Reforming Investor-State Dispute Settlement (ISDS): Conceptual Framework and Options for the Way Forward

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Reforming Investor-State Dispute Settlement (ISDS): Conceptual Framework and Options for the Way Forward

Stephan W. Schill

July 2015
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ABSTRACT

Provisions on investor-state dispute settlement (ISDS) have been a core component of international investment agreements (IIAs) for decades. Recognizing the need for neutral, independent, and efficient dispute settlement, IIAs react to shortcomings at the domestic level and grant foreign investors recourse to international arbitration against the host state for non-compliance with investment disciplines. This has been celebrated as depoliticizing investment disputes and contributing to enhancing the rule of law in investor-state relations. Yet, with the steep increase in investment treaty arbitrations during the past decade, ISDS has been facing a considerable backlash, including the retreat of some countries from the existing system, the recalibration of substantive investment disciplines, and debates about ways to reform ISDS at the national, regional, and international levels. Recurring concerns involve inconsistencies in decision making, insufficient regard by some arbitral tribunals to the host state's right to regulate in interpreting IIAs, charges of bias of the system in favor of foreign investors, concerns about the lack of independence and impartiality of arbitrators, limited mechanism to control arbitral tribunals and to ensure correctness of their decisions, and increasing costs for the resolution of investment disputes.

Reform debates are most heated in the context of the ongoing negotiations of "mega-regionals," which are likely to serve as standard-setters for IIA-making worldwide. ISDS reform is also on the agendas of various international organizations, including the United Nations Conference on Trade and Development (UNCTAD) and the Organisation for Economic Co-operation and Development (OECD). Together with the positions of particularly influential contracting parties to IIAs, such as the United States, the European Union, the Association of Southeast Asian Nations (ASEAN), and China, these processes will determine the global contours of the ISDS system for decades to come. It is therefore crucial that the debates about ISDS reform proceed in a well-informed manner and take into account the interests of all stakeholders in a balanced way.

Ensuring policy space and reaffirming state control over the system are core policy objectives of current efforts to reform the ISDS system. What is more, it is increasingly evident that only systemic reform will allow addressing concerns with ISDS in a comprehensive fashion. Yet, despite the growing consensus about the need for ISDS reform, the scope and modalities of, and strategies for, that reform remain contested. Options for the way forward range from exiting the system altogether to institutionalizing it further through the creation of an appellate mechanism or a permanent investment court, and establishing other instruments to ensure predictability and the protection of public interests.

For systemic ISDS reform to be successful, it is crucial to develop reform proposals on the basis of a normative and conceptual framework that is globally consented. This think-piece sets out the contours of such a framework. It suggests that the criticism has its origins in frictions with principles of constitutional law—democracy, the rule of law, and human rights. Responses should be framed within the same value system, that is, by reference to comparative constitutional principles that are globally shared, including principles of United Nations constitutional law and the concept of sustainable development. The conceptual framework thus developed can be used to formulate a number of concrete proposals for investment law reform, in particular increased institutionalization of ISDS and the implementation of mechanisms that allow states to ensure that ISDS develops in ways that are democratic, respectful of human rights, and in line with the demands of the rule of law.
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<tr>
<td>CETA</td>
<td>EU-Canada Comprehensive Economic and Trade Agreement</td>
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<td>EU</td>
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<td>ICSID</td>
<td>International Centre for Settlement of Investment Disputes</td>
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<td>international investment agreements</td>
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<td>ISDS</td>
<td>investor-state dispute settlement</td>
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<td>NAFTA</td>
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<td>TTIP</td>
<td>Transatlantic Trade and Investment Partnership</td>
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<td>TTP</td>
<td>Trans-Pacific Partnership</td>
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<td>UNCITRAL</td>
<td>United Nations Commission on International Trade Law</td>
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INTRODUCTION: GROWING CONSENSUS ON THE NEED FOR REFORM

Provisions on investor-state dispute settlement (ISDS) have been a core component of international investment agreements (IIAs) for decades.¹ Recognizing the need for neutral, independent, and efficient dispute settlement, IIAs react to shortcomings at the domestic level and grant foreign investors recourse to international arbitration against the host state for non-compliance with investment disciplines.² Recourse to international arbitration has been celebrated as depoliticizing investment disputes and contributing to enhancing the rule of law in investor-state relations.³ Yet, with the steep increase in investment treaty arbitrations during the past decade, a number of concerns with the current ISDS system have come to the fore, giving rise to widespread calls for reform. Recurring concerns involve inconsistencies in decision making, insufficient regard by some arbitral tribunals to the host state’s right to regulate in interpreting IIAs, charges of bias of the system in favor of foreign investors, concerns about the lack of independence and impartiality of arbitrators, limited mechanisms to control arbitral tribunals and ensure correctness of their decisions, and increasing costs for the resolution of investment disputes.

In reaction to these concerns, ISDS is facing a considerable backlash, including the retreat of some countries from the existing system, the recalibration of substantive investment disciplines, and debates about ways to reform it at the national, regional, and international levels. Reform debates are most heated in the context of ongoing negotiations of “mega-regionals,” such as the European Union (EU)-Canada Comprehensive Economic and Trade Agreement (CETA), the EU-United States (US) Transatlantic Trade and Investment Partnership (TTIP), and the Trans-Pacific Partnership (TPP). Although limited to specific IIAs, these debates are likely to have global repercussions, as mega-regionals increasingly serve as standard-setters for IIA-making worldwide. At the same time, ISDS reform is on the agendas of various international organizations, including the United Nations Conference on Trade and Development (UNCTAD) and the Organisation for Economic Co-operation and Development (OECD).⁴ Together with the positions of particularly influential contracting parties to IIAs, such as the US, the EU, the Association of Southeast Asian Nations (ASEAN), and China, these processes will determine the global contours of the ISDS system for decades to come. It is therefore crucial that the debates about ISDS reform proceed in a well-informed manner and take into account the interests of all stakeholders in a balanced way.

The current debates illustrate a growing consensus on the need to reform the ISDS system. Ensuring policy space and reaffirming state control over the system are core policy objectives of current reform efforts. What is more, it is increasingly evident that only systemic reform will allow addressing concerns with ISDS in a comprehensive fashion. Piecemeal approaches, in contrast, will only have limited effects as “old” IIAs continue to exist and investors are able to structure their investments to benefit from those treaties. Yet, despite the growing consensus about the need for ISDS reform, the scope and modalities of, and strategies for, that reform remain contested. Options for the way forward range from exiting the system altogether to institutionalizing it further through the creation of an appellate mechanism or a permanent investment court, and establishing other instruments to ensure predictability and the protection of public interests. In fact, the large number of reform proposals currently floated may risk fragmenting the international investment regime further and cause disorientation in undertaking systematic reform. Moreover, different reform proposals often reflect different (political, ideological, or institutional) preferences that may not be globally shared. All of this can be counterproductive in arriving at a system that is balanced, predictable, and legitimate for all stakeholders worldwide, in developed and developing countries alike, whether in government, private sector, or civil society.

For systemic ISDS reform to be successful, it is crucial to develop reform proposals on the basis of a normative and conceptual framework that is globally consented. This think-piece sets out the contours of such a framework in reaction to the current criticism of ISDS. It suggests that the criticism of the ISDS system has its origins in frictions with principles of constitutional law—democracy, the rule of law, and human rights. Responses to this criticism, in turn, should be framed within the same value system, that is, by reference to constitutional principles that are globally shared, including principles of UN constitutional law and the concept of sustainable development. The conceptual framework thus developed can be used to formulate a number of concrete

1 For general analyses and background see UNCTAD (2003, 2014); Gaukrodger and Gordon (2012).
2 Depending on the governing IIA, the applicable arbitration rules vary. Most commonly, IIAs refer to arbitration under the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States (ICSID Convention), the Arbitration Rules of the United Nations Commission on International Trade Law (UNCITRAL), and/or the Arbitration Rules of the Arbitration Institute of the Stockholm Chamber of Commerce. Possible causes of action also depend on the applicable IIA and may encompass breaches of the IIA in question (treaty claims), breaches of customary international law, breaches of investor-state contracts (contracts claims), and breaches of domestic law.
3 See the classic account in Shihata (1986).
4 See, for example, UNCTAD (2015: 119-73). For information on the OECD’s activities in international investment law, see http://www.oecd.org/daf/investment-policy/oecd-work-on-international-investment-law.htm.
proposals for investment law reform, in particular increased institutionalization of ISDS and the implementation of mechanisms that allow states to ensure that ISDS develops in ways that are democratic, respectful of human rights, and in line with the fundamental demands of the rule of law.

LEGITIMACY CRISIS OF INVESTMENT LAW AS A CONSTITUTIONAL CHALLENGE

Making proposals for ISDS reform requires taking stock of the status quo. From the perspective of foreign investors, investment treaty arbitration, which is offered in addition to, or as an alternative for, the host state’s domestic courts, has been successful in making host states comply with their IIA obligations in an effective, neutral, and independent forum for the settlement of investment disputes. In particular, in countries with weak government and judicial institutions, ISDS is considered to be a crucial safeguard to allow foreign investors to sanction illegitimate government conduct, such as arbitrary conduct or expropriations without compensation, without the need to being subject to the vagaries of litigating against the host government in its own courts. In addition, direct recourse to ISDS replaces the otherwise available mechanism for the investor’s home state to exercise diplomatic protection, thus preventing an investor-state dispute from becoming a diplomatic incident that can strain inter-governmental relations (Johnson and Gimblett 2012: 649).

At the same time, the success of ISDS has created its own problems and generated vocal criticism, which is often said to have resulted in a “legitimacy crisis” of the system (see Brower and Schill 2009: 471; Van Harten 2007; Van Harten et al. 2010; Sornarajah 2015). Signs of this crisis are seen in the recent withdrawal of some Latin American states from the International Centre for Settlement of Investment Disputes (ICSID) Convention (Bolivia, Ecuador, Venezuela); the withdrawal of some states from IIAs or entire IIA programs (including Ecuador, Venezuela, South Africa, the Czech Republic, and Indonesia); abstaining from including ISDS in new IIAs (which was Australia’s policy for a time); or recrafting the substance and procedure of IIAs to increase state control and ensure government policy space. Further, ISDS has become the focal point of criticism in IIAs by public interest groups, in particular in Europe and North America, by scholars from various disciplines, including constitutional law, international law, and economics, in the general media, and by the general public.

Claims for the lack of legitimacy are the common denominator of the current critique of ISDS. Recurring concerns in this context include the following.

- First, the increasing number of conflicting and inconsistent interpretations by arbitral tribunals of standard principles of investment protection, not only under different treaties, but also in virtually identical cases brought under the same treaty.

- Second, the wide latitude investment treaties give to arbitrators to interpret broadly formulated principles of investment protection, which creates uncertainty and unpredictability in arbitral decision making and gives arbitrators significant powers in further developing IIA disciplines.

- Third, the insufficient regard paid by some tribunals to the need for host states to regulate in the public interest, for example, to protect public health, labor standards, the environment, or to react to economic and financial crises.

- Fourth, the misalignment between governance effects of ISDS that go beyond the disputing parties and private law-inspired procedural maxims of arbitration, in particular confidentiality of proceedings, the understanding of independence and impartiality of arbitrators, and the idea that dispute settlement under investment treaties constitutes a party-owned process, in which non-parties, even if affected, are voiceless.

- Fifth, the lack of mechanisms to ensure “correct” interpretations of IIA obligations in line with the intentions of the contracting parties and to control the further development of investment law by arbitral tribunals.

- Sixth, the high costs and considerable length of many arbitral proceedings, including in cases that manifestly are lacking of merits or are even frivolous or abusive.

Common to all these aspects of criticism is that they do not principally concern the outcome of individual decisions rendered in ISDS, but concern ISDS as a system. Moreover, the criticism does not focus primarily on the function of arbitral tribunals to settle past disputes, but rather on the impact the ISDS system has on the future conduct of governments. ISDS, in other words, is analyzed and criticized as a system of governance in which individual tribunals exercise public authority—1) by reviewing government

5 Problems with domestic courts may involve a lack of personal or institutional independence of the domestic judiciary, including in some cases problems of corruption, or major shortcomings in the length of judicial proceedings. Furthermore, ISDS can serve as a mechanism to make states comply with their obligations in IIAs, given that these are not necessary directly applicable in domestic courts and cannot always be vindicated there. In such a case, a dispute settlement mechanism under international law is the only option for invoking breaches of the international legal obligations involved.
Arbitrators’ democratic legitimacy is limited to the state’s appointment of arbitrators and control of their decisions. The whole system far removed from democratic processes, both in the disciplines. On the contrary, arbitral tribunals are on the further development of investment law. Yet, arbitrators do not dispose of legislative functions that require decision makers’ even the further development of investment law, are in essence legislative functions that require decision makers’ democratic legitimation. Thus, there is no functioning separation of power between adjudicatory and legislative institutions, as required by the principle of democracy.

ISDS also poses a problem for the principle of equality, which is part of the democratic principle, because it only grants standing to foreign investors, while denying access to domestic investors who are limited to accessing domestic courts. Finally, the lack of transparency and of third-party participation pose a challenge to the openness and transparency the principle of democracy requires of the exercise of public authority and the possibility for everyone affected to have a voice in decision making through participatory rights. Finally, the protection of fundamental or human rights is affected by ISDS to the extent arbitral tribunals extend investor rights to the detriment of human rights.

Moreover, there is no functioning separation of power in ISDS as a system of governance and the appointment of some members of a tribunal in a concrete dispute. Moreover, there is no functioning separation of power between adjudicatory and legislative institutions, as required by the principle of democracy.

In many cases, ISDS proceedings deal with matters that are customarily considered as public law disputes. Claims concerning environmental conditions for the operation of power plants, the legality of subsidies, or the prohibition of harmful substances are examples of what are in essence administrative law disputes. Claims against Uruguay and Australia on cigarette packaging, or the claim concerning Germany’s nuclear power phase-out, are examples of genuinely constitutional law disputes settled in arbitration. In this context, law-making occurs, notwithstanding a considerable number of inconsistent decisions, because arbitral tribunals generally operate in a strongly precedent-oriented fashion in which they further develop and concretize the vague standards of treatment, such as fair and equitable treatment or the concept of indirect expropriation. See further Schill (2009: 321-61).

On the understanding of ISDS as a system of governance and the legitimacy concerns raised from a public law perspective, see Schill (2010). In many cases, ISDS proceedings deal with matters that are customarily considered as public law disputes. Claims concerning environmental conditions for the operation of power plants, the legality of subsidies, or the prohibition of harmful substances are examples of what are in essence administrative law disputes. Claims against Uruguay and Australia on cigarette packaging, or the claim concerning Germany’s nuclear power phase-out, are examples of genuinely constitutional law disputes settled in arbitration. In this context, law-making occurs, notwithstanding a considerable number of inconsistent decisions, because arbitral tribunals generally operate in a strongly precedent-oriented fashion in which they further develop and concretize the vague standards of treatment, such as fair and equitable treatment or the concept of indirect expropriation. See further Schill (2009: 321-61).
TOWARDS A (COMPARATIVE AND INTERNATIONAL) CONSTITUTIONAL LAW FRAMEWORK FOR ISDS REFORM

As the above analysis shows, the legitimacy crisis in international investment law becomes understandable as a challenge to core constitutional values and constitutional principles that are common to many domestic legal systems in the world and their interaction with institutions of global governance. As a consequence, a response to these challenges must be developed within the same normative framework. The constitutional challenge to ISDS, in other words, can only be resolved through a constitutional response. In fact, the constitutional framework of some IIAs contracting parties expressly mandates this. Article 21 of the Treaty on European Union, for example, requires the EU’s external action to be guided by its own constitutional principles, namely “democracy, the rule of law, the universality and indivisibility of human rights and fundamental freedoms, respect for human dignity, the principles of equality and solidarity, and respect for the principles of the United Nations Charter and international law.” The constitutional law of other countries also suggests that external action and the design of international dispute settlement systems, such as ISDS, must be in line with fundamental constitutional values and principles.7

Yet, to serve as a basis for global consensus for ISDS reform, constitutional analysis cannot draw on specific national constitutional understandings. Instead, a broader and more open constitutional framework is necessary. Two sources of constitutional norms and values are particularly apposite in this context—first, principles of comparative constitutional law and, second, multilaterally consented principles of UN law that serve as the constitutional law of the international community. Finally, the principle of (sustainable) development, which emerges as a global constitutional principle, can serve as a basis for guiding ISDS reform.

PRINCIPLES OF COMPARATIVE CONSTITUTIONAL LAW

The first set of principles that can inform the development of a constitutional law framework for ISDS reform can be distilled through recourse to a comparative analysis of how domestic constitutional law and the constitutional law of supranational organizations, such as the EU or ASEAN, envision the relationship between the state and private economic actors and circumscribe the role and potential authority of international dispute settlement institutions to review government conduct. Yet, to develop a global consensus, comparative analysis must draw on a wide variety of constitutional systems from all corners of the world and cannot be limited to a comparative canon of Western legal systems.

While a more in-depth study would be required, it seems clear that principles that are broadly recognized in domestic constitutional law in a large variety of countries across all regions of the world include the principles of democracy, the concept of the rule of law, and the protection of fundamental and human rights. These principles could be used not only to suggest a more balanced interpretation of investment treaties,8 but also to guide a global ISDS reform agenda. Indeed, these principles suggest that the future ISDS system must be designed to be a democratic system that furthers the rule of law and safeguards fundamental and human rights. Developing principles of comparative constitutional legitimacy would respond head on to ISDS criticism.

First, a comparatively grounded and concretized principle of democracy would require the ISDS mechanism to be structured in a way that leaves sufficient policy space for host states under IIAs disciplines to regulate in the public interest. It also requires that there are democratic control mechanisms to channel, and if needed to correct, the law-making activity of the ISDS mechanism. The principle of democracy also backs demands for increased transparency in ISDS and for participation of non-disputing third parties that are affected by ISDS proceedings, for example through amicus curiae submissions. Similarly, the principle of democracy would support the participation of global public interest organizations in ISDS proceedings to act as advocates for specific global interests that an ISDS proceeding may involve.

7 Within the EU, and particular in Germany, there is now an emerging scholarly debate as to what limits constitutional law imposes on the participation of the EU and its member states. See, for example, Schill (2013); Oehler (2015); Fischer-Lescano and Horst (2014). For a US perspective, see Rutledge (2013).

8 This was done in the contributions to Schill (2010).
Second, the protection of fundamental and human rights is a globally shared constitutional concern that can serve as a yardstick to redesign ISDS. It requires that decisions taken by an ISDS mechanism have regard for competing non-investment concerns, and that they do not create obstacles or excuses for governments to fall short of fulfilling human rights obligations.

Finally, respect for the rule of law constitutes a globally recognized constitutional principle that can guide ISDS reform. The rule of law demands coherence and predictability in ISDS, and it also calls for structuring ISDS in a way that access to justice does not become prohibitive, in particular for small and medium-sized investors. Moreover, the concept of the rule of law constitutes a yardstick for concretizing the standards of independence of ISDS decision makers and the procedures they should apply in administering justice in ISDS.

**PRINCIPLES OF UN CONSTITUTIONAL LAW**

As IIAs are instruments of international law, they should not only align with principles of comparative constitutional law, but also fit with fundamental principles of international law. Thus, the second set of principles that can serve as a basis for developing a conceptual framework for ISDS reform stems from UN constitutional law. One norm of UN constitutional law in particular should be placed at the center of the current reform debates. This is Article 55 of the UN Charter.

**Article 55**

With a view to the creation of conditions of stability and well-being which are necessary for peaceful and friendly relations among nations based on respect for the principle of equal rights and self-determination of peoples, the United Nations shall promote:

1. higher standards of living, full employment, and conditions of economic and social progress and development;
2. solutions of international economic, social, health, and related problems; and international cultural and educational cooperation; and
3. universal respect for, and observance of, human rights and fundamental freedoms for all without distinction as to race, sex, language, or religion.

Although this provision is addressed to the UN, it can be read, together with Article 56, as setting out broader constitutional principles for the organization of international relations. These principles can also form part of a normative framework for ISDS reform. Article 55 of the UN Charter contains a number of principles that appear central in this context—1) ensuring international peace and security and the peaceful settlement of disputes; 2) the protection of self-determination; 3) the principle of sovereign equality; 4) the protection of human rights; and 5) development and social progress.

Read in the light of these principles, investment law and ISDS reform need to be conceptualized as tools for states to achieve “peaceful and friendly relations” that “respect ... the principle of equal rights and self-determination” to work towards “higher standards of living ... economic and social progress and development,” while “respect[ing] ... human rights and fundamental freedoms.” This perspective would stress 1) the objective of investment law to govern international investment relations peacefully, among others, by providing mechanisms for peaceful settlement of disputes; 2) the need for investment law to give sufficient policy space to states to pursue their development strategies autonomously; 3) the equal application of investment rules to both capital-importing and capital-exporting countries; 4) the vision to regulate not only state behavior vis-à-vis foreign investors, but also that of investors vis-à-vis states and other affected communities; and 5) the importance of human rights in informing international investment relations and ISDS reform.

**THE PRINCIPLE OF (SUSTAINABLE) DEVELOPMENT**

Finally, the principle of (sustainable) development, understood by the Brundtland Commission as “development that meets the needs of the present without compromising the ability of future generations to meet their own needs,” has particular importance as a guiding principle for ISDS reform. Sustainable development is found both as a principle of constitutional law in many domestic legal orders and an expression of a fundamental principle governing international relations.\(^9\) Applied to international investment relations, the principle of sustainable development requires understanding investment law not as an obstacle to development but as a tool for host states to achieve their development objectives. That this is possible in practice is shown by UNCTAD’s Investment Policy Framework for Sustainable Development, which translates the concept of sustainable development into concrete formulations of investment treaty provisions (2012: 97ff).

Reconceptualizing international investment law in light of the principle of sustainable development is necessary considering the importance the UN and its members attribute to increasing investment for achieving the UN Millennium Development Goals and countries’ development agendas more generally, as expressed, among others, in the

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The currently debated options have the termination of IIAs and/or the ICSID Convention and more generally disengaging from ISDS (or certain forms of it). Such conduct is backed by the desire to strengthen domestic democratic control, subjecting investor-state relations to domestic (including constitutional) law, and having investor-state disputes settled by domestic courts that may be seen as more democratically legitimate than international ISDS mechanisms. Subjecting relations between foreign and investors and host states to domestic law only gives precedence to domestic constitutional values over the idea of balancing the interests of both the host state and foreign investors. Yet, solely subjecting foreign investment relations to domestic law and domestic courts is less in line with a cosmopolitan understanding of democracy because foreign investors are not part of the host state’s constituency, do not benefit from the same civil and political rights as citizens, and are unable to participate in the election of a government. The return to domestic law and domestic courts is therefore a manifestation of a limited idea of (national, not cosmopolitan) democracy.

**OPTIONS FOR INVESTOR-STATE DISPUTE SETTLEMENT REFORM**

ISDS reform should be guided by the constitutional principles (comparative and international) outlined above. This requires rethinking it in constitutional law terms and breaking with the prevailing private law thinking in many quarters of ISDS practice. Instead, ISDS reform options should be evaluated with respect to the extent to which they meet the demands of a democratic system that is in line with the rule of law, protect fundamental or human rights, and contribute to (sustainable) development. It is against these principles that current reform options should be measured. The currently debated options have the termination of investment treaties and disengagement from the ISDS system at one end of the spectrum. At the other end are proposals involving a further institutionalization of ISDS, in particular the creation of a standing appellate mechanism or the establishment of a permanent international investment court. In addition, the principles of democracy and the rule of law can be used to back additional elements the future ISDS system should integrate.

**TERMINATING INTERNATIONAL INVESTMENT AGREEMENTS AND DISENGAGING FROM INVESTOR-STATE DISPUTE SETTLEMENT**

One option for the reform of the ISDS system is terminating IIAs and/or the ICSID Convention and more generally disengaging from ISDS (or certain forms of it). Such conduct is backed by the desire to strengthen domestic democratic control, subjecting investor-state relations to domestic (including constitutional) law, and having investor-state disputes settled by domestic courts that may be seen as more democratically legitimate than international ISDS mechanisms. Subjecting relations between foreign and investors and host states to domestic law only gives precedence to domestic constitutional values over the idea of balancing the interests of both the host state and foreign investors. Yet, solely subjecting foreign investment relations to domestic law and domestic courts is less in line with a cosmopolitan understanding of democracy because foreign investors are not part of the host state’s constituency, do not benefit from the same civil and political rights as citizens, and are unable to participate in the election of a government. The return to domestic law and domestic courts is therefore a manifestation of a limited idea of (national, not cosmopolitan) democracy.

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1. [UNCED, “Agenda 21: Programme of Action for Sustainable Development,” 14 June 1992, UN Doc A/Conf.151/6/Rev.1, para 2.23: “Investment is critical to the ability of developing countries to achieve needed economic growth to improve the welfare of their populations and to meet their basic needs in a sustainable manner, all without deteriorating or depleting the resource base that underpins development. Sustainable development requires increased investment, for which domestic and external financial resources are needed. Foreign private investment and the return of flight capital, which depend on a healthy investment climate, are an important source of financial resources.”](#)

2. [United Nations, “Monterrey Consensus on Financing for Development,” 22 March 2002, UN Doc A/AC.257/32, para 21: “[a] transparent, stable and predictable investment climate, with proper contract enforcement and respect for property rights, embedded in sound macroeconomic policies and institutions that allow businesses, both domestic and international, to operate efficiently and profitably and with maximum development impact.”](#)

3. [Similarly, the Rio+20 Conference led to the adoption of the Outcome Document “The Future We Want” that called for increased investment in sustainable agriculture and rural development, water resources and sanitation services, clean energy technology, sustainable tourism, infrastructure, research and development, and education. See Annex to UNGA Res No 66/288, 11 Sep 2012, (UN Doc A/Res/66/288, paras 110, 123, 127, 131, 149, 154, 188, 201, 232, 271).](#)

4. [I am only referring here to real persons, as corporations, including domestic ones, do not have political rights either. Yet, the shareholders of corporations that are real persons and have the nationality of the host state are able to participate in elections, unlike shareholders with foreign nationality.](#)
Moreover, as a systemic reform strategy, terminating IIAs and disengaging from ISDS has significant limits because it does not allow reforming the existing ISDS system in a comprehensive fashion. First, to be effective, a host state regularly has to withdraw from all of its investment treaties; otherwise, investors will be able to structure or restructure their investments to come under the scope of protection of one of the remaining investment treaties. Second, because of survival or sunset clauses with a term of up to 20 years, the termination of IIAs does not end the protection of existing investments under the existing system. Terminating IIAs and disengaging from ISDS will therefore be unable to substantially change the existing system. Further, disengaging from ISDS is likely to affect small and medium-size investors more than multinational companies, who are able, because of their greater negotiating power, to have access to ISDS on a contractual basis.

Most importantly, however, terminating IIAs and disengaging from ISDS sits uneasily with the concept of the rule of law as it may relegate foreign investors to settling disputes with host states in domestic courts, a forum that in some cases may not meet the standards of independence, impartiality, and neutrality required for dispute settlement under the rule of law, or may be perceived by foreign investors not to meet these standards. While access to justice in investor-state relations can be granted in domestic courts, it only meets the requirements of the rule of law if those courts are in a position to enforce the promises the host state has made vis-à-vis foreign investors (under domestic law, in investor-state contracts, or under IIAs) against the will of the state and hold it accountable under these standards. If this is not the case, both in developed and developing countries (due to a lack of independence, neutrality, or impartiality, corruption, inefficient procedures, or inapplicability of IIAs in domestic courts), domestic solutions will not be able to meet the requirements of the (international) rule of law. Diplomatic protection and inter-state dispute settlement are not a sufficient alternative either, as it subjects foreign investors to the discretion of home governments. In consequence, only a right to individual access to an international ISDS mechanism is able to fulfill an investor’s right to access to justice.

In sum, ISDS is an institution worth preserving because it can serve as an accountability mechanism for host government conduct, which embodies and implements the concept of the rule of law. Proposals to limit access to this institution by foreign investors should be analyzed critically and assessed in light of the question whether alternatives are able to serve the interests of host states in preserving sufficient policy space, and whether they can hold these states accountable under the substantive standards contained in IIAs. In many cases, only having domestic courts to settle investor-state disputes cannot fulfill the requirements of the constitutional principle of the rule of law and the need for foreign investors to have access to justice. Terminating IIAs and disengaging from ISDS is therefore not a recommended option for systemic ISDS reform that answers to the criticism above. Instead, some form of ISDS should be preserved.

Yet, the fact that ISDS is only open to foreign investors requires further thought as a constitutional problem. After all, it allows foreign investors either to bypass domestic courts entirely or at least gives them an additional remedy that domestic investors do not have. By ousting domestic courts entirely from the possibility of controlling the host state’s executive and legislative branches, this risks creating a parallel justice system and poses a challenge to the principle of democratic equality. While having an additional remedy can be justified from a democratic perspective because the foreign investor is not part of the demos of the host state, the disenfranchisement of domestic courts should be avoided.

Instead, ways to integrate domestic adjudication and ISDS in a smart way should be further explored. Several models could be considered. The lump sum requirement that local remedies must be exhausted before access to ISDS would be the traditional model used in diplomatic protection and human rights adjudication. As a general solution, this is, however, not recommended as it brings the domestic judiciary, usually a multi-tiered system (with all of its problems in many countries), back into the picture. A better solution would be requiring a more focused recourse at the domestic level, which is subject to a limited period of time before ISDS proceedings can be initiated. Such a prior recourse could take place in a domestic court with specific expertise, including in matters of international investment law, to resolve the dispute swiftly and professionally. Special chambers in appeals courts or even supreme courts that are staffed with regular judges from the host state’s judiciary may be an option for such prior domestic recourse. This would ensure that domestic judicial institutions with judges...
who possess immediate democratic legitimacy get a first shot at controlling government conduct before a case can proceed to ISDS.

**INCREASED INSTITUTIONALIZATION: APPPELLATE MECHANISM VERSUS PERMANENT COURT**

While terminating IIAs and disengaging entirely from ISDS will not further access to justice and efficient dispute settlement in investor-state relations, the existing arbitral system needs fundamental reform to make it more democratic and bring it in line with the demands stemming from the concept of the rule of law. Thus, to remedy the problem of inconsistencies, a more centralized ISDS system is needed. This is only achievable through increased institutionalization and the establishment of some centralized dispute settlement body. Two options for increased institutionalization of ISDS exist—1) the introduction of an appellate mechanism that could be added as a second instance for the revision of errors of law made by arbitral tribunals as the first instance; or 2) the establishment of a permanent investment court that would entirely replace the existing arbitral system, potentially consisting of a two-tier system with trial and appeals chambers.

Both options would bring ISDS more in line with constitutional principles. Both an appellate mechanism and a permanent investment court would serve the rule of law by introducing an additional instance that could ensure the correctness of decisions rendered in ISDS. Both an appellate mechanism and a permanent investment court would also increase coherence in ISDS and contribute to the emergence of a jurisprudence constante (a consistent and stable jurisprudence). This would reduce uncertainty in decision-making and increase predictability and legal certainty for both investors and host governments. It would require, however, that both an appellate mechanism and a permanent investment court are set up as multilateral institutions that are able to oversee ISDS cases independently of the disputing parties and the applicable IIA. Further, the extent to which permanent institutions can increase consistency in decision-making will also depend on the applicable law. If the law remains essentially enshrined in bilateral treaties, consistency will be more difficult to achieve, and perhaps be contrary to the intentions of state parties than in a multilateral setting.

Finally, an appellate mechanism as well as a permanent investment court would allow controlling law-making activities in ISDS and thereby make the international investment regime more democratic. This is particularly the case if members of the respective mechanisms are appointed by participating states in democratic processes, which are modeled, for instance, on how judges of other international courts are selected. Similarly, problems with conflicts of interests could be avoided if members of a standing appellate mechanism or investment court are not allowed to act as counsel in ISDS proceedings. This would ensure more independence and impartiality compared to the present arbitral system.

Both an appellate mechanism and permanent investment court would have similar benefits in terms of creating coherence and a better balance in ISDS jurisprudence. The advantage of an appellate mechanism over a permanent investment court would likely be that its creation is politically easier to achieve than the establishment of a multilateral investment court. While the enthusiasm to create international courts has generally declined since the 1990s and given way to a certain degree of disillusion (see Schill 2015), several major players, including the US and the EU, have indicated in their IIA practice the willingness to create an appeals facility for ISDS decisions. Further, an appellate mechanism could be combined with the existing arbitral system as a first instance. Such a system could draw on the experience in WTO dispute settlement, where the WTO Appellate Body oversees a system of panels that are put together for each individual dispute. Compared to a permanent court with tenured judges that would need to be paid independently of the existence of actual cases, such a system is likely more cost efficient. While many technical and political difficulties would need to be addressed, the creation of an appellate body could either be integrated through a reform of the ICSID Convention into the ICSID system or set up independently through an opt-in process modelled on the approach taken by the Mauritius Convention.

Yet, the establishment of an appellate mechanism or a permanent investment court comes with its own problems. Notably, the introduction of centralized dispute resolution institutions, whether appellate mechanism or court, could raise its own legitimacy concerns that need to be addressed. Apart from the question of who sits as decision-makers, and who appoints or elects them, permanent institutions may display stronger dynamics in enlarging their jurisprudential powers than a system of one-off arbitral tribunals. After all, a permanent institution could develop international investment law much more consistently, including in ways governments may not agree with. In addition, the influence of individual states on who gets to sit as decision-makers in a permanent institution is likely going to be lower compared to the current arbitral system where the majority of the arbitrators on a tribunal generally require support of the state party to the dispute. Both aspects arguably move a standing appellate mechanism or permanent court further away from democratic processes and the democratic influence of individual states.

To control the way an appellate mechanism or permanent investment court reviews government conduct and further develops applicable IIA standards, and to ensure that in doing so it respects the host state’s right to regulate in the public interest, a legislative counterweight in the form of an assembly of states parties, or ministerial committee,
would have to be established. By issuing binding guidelines for future decision-making, such a body could control both the further development of IIA disciplines and readjust the balance that it strikes in interpreting IIA disciplines between investment protection and competing non-investment concerns. Its precise competences would need to be limited to the multilateral aspects of a to-be-established court or appellate mechanism. For all bilateral aspects, such as those currently governing substantive law, states could install joint committees as part of their IIAs, which could issue binding interpretations of IIA standards. This would be another way to increase state control as a counterweight to a more institutionalized ISDS system. Examples of such committees already exist in a number of IIAs, following the model of the North American Free Trade Agreement (NAFTA) Free Trade Commission. Such committees would ensure that the ISDS system is subject to democratic control, to be exercised jointly by the contracting parties.

**POTENTIAL FURTHER INVESTOR-STATE DISPUTE SETTLEMENT INNOVATIONS**

Constitutional principles, such as the principle of democracy and the concept of rule of law, do not only call for a more institutionalized ISDS system that is combined with democratic control mechanisms. These principles also support a number of other innovations in ISDS. Some of them are discussed in a loose order in this sub-section.

First, constitutional principles are not just a yardstick for reforming the institutional set-up of ISDS. They should also influence how ISDS procedures are to be reformed. Independent of whether investor-state disputes are settled through arbitration or in permanent institutions, such as an appellate mechanism or a permanent investment court, constitutional law-inspired procedural institutions will be able to ensure that ISDS is more democratic and enhances, rather than obstructs, the rule of law. Thus, to increase both the accountability of decision-makers in ISDS and their democratic legitimacy, transparency is perhaps the most important principle that should be implemented. Similarly, the possibility of third parties to participate in ISDS, as amicus curiae or non-disputing parties should be enhanced as it reflects the democratic principle that those who are affected by an act of public authority must have a voice in the processes leading up to the act in question. The reform of the ICSID Rules in 2006, the coming into effect of the UNCITRAL Rules on Transparency in Treaty-based Investor-State Arbitration in 2014, and transparency rules and rules on third-party participation in a number of IIAs implement these principles, as does the recently concluded Mauritius Convention on Transparency. Compulsory transparency, with appropriate exceptions for business secrets and national security interests, as laid down in the UNCITRAL Rules and the Mauritius Convention, should become a firm pillar of ISDS reform. All states and supranational organizations should be encouraged to sign the Mauritius Convention.

Second, the concept of the rule of law and the principle of democracy demand that those who act as adjudicators in ISDS, whether as arbitrators or in permanent institutions, such as an appellate mechanism or permanent investment court, do so in an impartial and independent manner. While the principles of independence and impartiality already govern the existing ISDS system, the one-off nature of investment arbitration has led to concerns about conflicts of interests arising out of the multiple roles individuals can assume in different investment arbitration cases, acting as arbitrator in one, as counsel in another, and as expert in yet another. The clearest solution would be to exclude such a confusion of roles altogether. Yet, more clarity on the ethical standards in place for dispute resolvers in other situations would also be desirable. Clearer ethical rules should be ensured through the development of more comprehensive codes of conduct for ISDS procedures.

Third, increasing the efficiency and cost effectiveness of ISDS is mandated by the principle of the rule of law. After all, review of government conduct can only be an expression of the concept of the rule of law if it is implemented without undue delay and at affordable cost. Decreasing costs concerns not only the costs of arbitral institutions and arbitrators, but, more importantly, the costs of legal representation and experts, which on average make up more than 80% of total costs (Gaukrodger and Gordon 2012: 19). This would call for decreasing the length and costs of ISDS proceedings, and for introducing mechanisms that help parties in need of financial assistance. This holds true particularly for small and medium-sized investors who need lean and cost-efficient dispute settlement options in ISDS to effectively enjoy their right to access to justice. Having "small claims court"-type arrangements may be one option; another would be to use sole arbitrators and apply streamlined procedures that allow a quicker but nevertheless fair resolution of investor-state disputes. Yet, access to justice in ISDS is also a concern for respondent states, in particular those with limited budgets and little experience in ISDS. To ensure that such states are able to defend themselves adequately and fairly in ISDS, an investment dispute advisory center, comparable to the Advisory Centre on WTO Law, could be established that provides them with expertise on ISDS at lower costs. Third-party funding may be another source of finance for dispute settlement, but its drawbacks must be carefully weighed. The effectiveness of ISDS proceedings may be further increased through appropriate cost rules, such as the loser pays principle and cost shifting for certain types of behavior. ISDS adjudicators will have to play an active role in structuring proceedings so that they are conducted swiftly but fairly.

Fourth, for host states to avoid liability under IIAs in the first place, it is important that appropriate mechanisms are introduced domestically to screen whether government measures are a potential cause for liability under IIAs. An IIA impact assessment mechanism could help to prevent IIA disputes from arising in the first place. Such a mechanism would contribute to implementing the international rule
This think-piece has argued that in response to widespread criticism that it lacks legitimacy, the ISDS system should be brought more in line with (international and comparative) constitutional principles. This would answer concerns expressed about the existing ISDS system in the same language used by critics, that is, the language of constitutional law. Drawing on comparative and international constitutional analysis allows an understanding of ISDS as an institution that helps implement the international rule of law in investor-state relations. It also requires that the ISDS system be reformed to make it more democratic and to subject the existing system to an appropriate degree of state and democratic control.

To achieve an ISDS system that better serves the rule of law, democracy, and human rights, this think-piece recommends that individual recourse by investors to ISDS should be maintained, while reform efforts are necessary both at the institutional and procedural levels. This requires more institutionalization of ISDS and a smart integration of ISDS and domestic court proceedings. More institutionalization could be achieved through the establishment of a permanent investment court or, preferably, through the creation of an appellate mechanism that could be added on top of the existing arbitral system. Similarly, the procedures applied in ISDS, whether by arbitrators, appeals judges, or permanent judges, should be rethought in the light of constitutional principles. Transparency of ISDS should be increased and independence and impartiality of decision-makers enhanced. Finally, ISDS procedures must become more efficient and cost effective.

At the same time, it is important to note that reforming ISDS is in itself not sufficient to solve all problems that the international investment regime faces. Many problems of the current regime, such as those concerning vagueness and ambiguity of substantive standards of treatment, the lack of clarity of the rights of states vis-à-vis foreign investors, and the inexistence of enforceable investor obligations under international law, can only be tackled through a reform of substantive standards. Likewise, achieving complete coherence will not be possible if many thousand IIAs continue to exist. To achieve a better balance, more coherence, and arrive at a generally more legitimate international investment regime, reforming the substance of investment treaties and reconsidering the form in which they are concluded (whether as bilateral, regional, or multilateral treaties) are equally necessary. Likewise, it will be important that investment treaty disciplines are effectively implemented domestically to avoid liability in the first place. This will require the development of appropriate compliance and IIA impact assessment procedures. After all, reforming the ISDS system is only one, although an important, aspect of a broader reform of the international investment regime.
REFERENCES


Implemented jointly by ICTSD and the World Economic Forum, the E15 Initiative convenes world-class experts and institutions to generate strategic analysis and recommendations for government, business, and civil society geared towards strengthening the global trade and investment system for sustainable development.