Feature

KEY POINTS

- The institution of investor state proceedings in ICSID leads to significant reductions in the inward flow of foreign direct investment.
- A state which eventually loses an ICSID dispute will experience even greater losses in inward foreign direct investment.
- A second risk for the state is that there may subsequently be a number of other claims brought against the state which relate to entirely different causes of action against the state.
- These risks should also be factored into a state's decision-making process when evaluating the pros and cons of settling investment claims.

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The resolution of investment disputes by arbitration: risks facing host states

In this article, the authors consider the very significant potential risks facing host states which are sued in ICSID.

INVESTMENT ARBITRATION AGAINST STATES

During the second half of the 20th century, as empires and their economic infrastructure collapsed and a new global economic order emerged, states needed to attract foreign investments in order to develop their economies. In particular, newly independent states in the developing world needed inward investment. To succeed, these states had to reassure investors that their investments would benefit from, and be safeguarded by, a reliable and fair legal framework. States accordingly started to conclude treaties on the promotion and protection of foreign investments, these being referred to as bilateral investment treaties (BITs). Subsequently, this phenomenon has evolved and a significant number of multilateral treaties were concluded with investment protection provisions being a key focus (eg the Energy Charter Treaty or the ASEAN Comprehensive Investment Agreement) or with such provisions being embodied as part of a multilateral trade agreement (eg the North American Free Trade Agreement or the Comprehensive and Economic Trade Agreement between the EU and Canada). Today there are more than 2364 bilateral investment treaties in force and numerous other multilateral treaties with investment protection provisions.[1]

These treaties contain substantive provisions protecting investors from adverse consequences that states' decisions may cause to the value of their investment. For example, the BITs commonly provide guarantees to an investor that their investments will be subjected to fair and equitable treatment (the "FET" standard) and measures that are non-discriminatory. They also almost invariably codify the customary international law principle that foreign investments shall not be expropriated by a host state unless for a public purpose, under due process of law and for prompt, adequate and effective compensation.

A number of international investment arbitral tribunals have given content to what constitutes the FET standard. While there is a degree of disagreement between various Tribunal decisions, and an on-going debate amongst practitioners and scholars on core issues, a number of specific constituent duties encompassed by the FET standard, as spelt out by a number of arbitral tribunals, may be summarised as follows:

- the duty to protect investors' legitimate expectations;
- the duty to act transparently;
- the duty not to act arbitrarily;
- the duty not to subject the investor to discriminatory treatment;
- the duty not to deny the investor justice; and
- the duty to act in good faith.

To ensure that such substantive protections were not simply paper rights, a widespread view emerged – as evidenced by the terms of the BITs themselves – that it was necessary for them to establish a neutral forum for dispute resolution by conferring on investors the right to bring claims for BIT violations against a host state before an international arbitration tribunal. The theoretical possibility of an investor having recourse to a host state's courts was considered insufficient protection given that both access to the courts and the existence of these rights being a viable cause of action depended entirely on the host state's laws, but also the rights in question were conferred ostensibly by treaty and as such it was inappropriate that one state party's courts should render an interpretation and application of treaty rights that operated on the international plane.

Accordingly, many BITs contain a dispute settlement clause which confers on investors a right to refer their claims against the host state to an international arbitration tribunal. Typically the clause stipulates in terms which institution or arbitration rules have been chosen by the state parties to the BIT to settle disputes arising out of the treaty, but a number of BITs will give investors a choice between different forums. Arbitration conducted pursuant to the International Centre for Settlement of Investment Disputes (ICSID) Convention or the United Nations Commission on International Trade Law Arbitration Rules (UNCITRAL Rules) is most common. From a total of 808 investment disputes that have been, or are being, arbitrated as at the time of writing, 55% of them are administered under ICSID rules and 31% under UNCITRAL rules.[2]

RISKS FACING A STATE ARISING FROM THE INSTITUTION AGAINST IT OF AN INVESTMENT ARBITRATION

When considering the risks facing a state that has been sued for breach of a BIT before an investment arbitration tribunal,

the most obvious risk is that it may lose the case with the attendant risk of an award of compensation being granted to the investor. There are, however, two less obvious risks that arise for the host state from the institution against it of an investment treaty case. First, there is potentially a significant risk posed to current and future capital inflows to the state. Second, there is potentially a significant risk of an increase in the number of investment treaty claims being brought against the state. These risks are now considered in turn.

In terms of the first of these risks, a state being sued under an international investment agreement leads potentially to a significant risk of:

- a negative impact on foreign direct investment into the state; and
- a perception amongst foreign investors that the state is willing to act in disregard of international legal standards of protection of foreign investment.

In sum, these risks arise from the following two reasons:

- The institution of investment arbitration proceedings against a state serves as an important *ex post* signalling factor to the investment community that there are highly problematic issues relating to the government's treatment of a foreign investor; and
- There would appear to be a statistically significant and negative correlation between the filing of investment arbitration proceedings against a state and the level of foreign direct investment into that state.

A review of available data and econometric analyses demonstrates that the initiation of investor-state arbitration is negatively correlated with the level of foreign investment into a host state. In particular, an econometric study by Allee and Peinhardt, "Contingent credibility: The impact of investment treaty violations on foreign direct investment", 65(3) *International Organization* (2011), p 401 states at p 412 that empirical evidence "reflect[s] that both investment treaties and investment disputes before ICSID serve as important informational shortcuts for firms when they make these investment decisions".

Significantly, Allee and Peinhardt go on to state at p 414:

> "Firms may want to believe that host states are innocent until proven guilty, but *a host country's appearance before ICSID already conveys a negative signal regarding its relationship with another foreign investor and its possible noncompliance with a BIT. … Because challenging a government's treatment of FDI before ICSID is a costly and time-consuming endeavor, formally registering a dispute sends a strong message to the international investment community about the government's allegedly poor behavior.* Of course, not all governments who appear as ICSID respondents have violated the terms of a BIT; those issues are left for an ICSID panel to decide. But the initial filing of a dispute before ICSID is likely to give pause to current and future investors. *The registration of a dispute at ICSID also reflects an unwillingness on the part of the accused government to grant any accommodation to the aggrieved investor or to resolve the dispute short of international arbitration. This antagonistic attitude is likely to be poorly received by other investors. Therefore, the filing of a case before ICSID immediately brands the respondent country as an actor that is hostile to investors.* We believe this initial signal is particularly revealing because it contradicts the host country's earlier attempts to cultivate a better reputation through signing BITs. The effects of this initial negative signal should then last throughout the duration of a dispute's tenure under ICSID jurisdiction." (Emphasis added.)

Allee and Peinhardt go on to conduct an econometric analysis of a sample of 83 host states and 39 source states in the period 1984-2007. Their other "*Primary Findings*" at p 421 includes a strident statement based on their analysis that the institution of investor state proceedings in ICSID leads to "statistically and substantively significant reductions in inward flow of foreign investment" (emphasis added). Moreover, a quantification of the associated losses of a state being sued before ICSID leads the authors to conclude that even a single ICSID proceeding commenced against a host state government will on average offset the FDI gains associated with the signing of between two to three additional bilateral investment treaties.

The position for a host state is exacerbated in terms of foreign direct investment flows as the number of disputes against a state increases. As Allee and Peinhardt state at p 423:

> "Table 3 shows that in substantive terms, each pending ICSID case against a government is associated with a $55 million reduction in annual FDI on average. This finding suggests that investors react not only negatively but also swiftly to an ICSID filing, without giving respondent governments the benefit of the doubt or allowing them the benefit of an arbitration hearing." (Emphasis added.)

Moreover, the authors also find that institution of an ICSID case against a state has an effect that lingers past the date of the initial filing and that the number of ICSID filings in the past two and five years are both found to be significant predictors of lower FDI levels at "a 99 per cent level of confidence" (p 423).

A state who eventually loses an ICSID dispute will experience even greater losses in inward foreign direct investment. As the study states at p 425:

> "The substantive effects of losing an ICSID award are large. *Governments on average stand to lose more than $791 million in FDI annually if they have lost an ICSID dispute in the past two years* (see column 5.1 in Table 5), *which effectively outweighs the benefits provided by signing twenty-five additional BITs. These losses persist fairly robustly over time, too.* Each ICSID ruling that a government has lost within the past five years is associated with a substantial loss of $663.8 million in FDI (see column

5.2 in Table 5). Stated differently, the FDI benefits of signing more than twenty BITs (20 X $25.6 million) would be outweighed by the reputational costs of losing a single ICSID panel ruling during the past five years. These findings demonstrate that a clear violation of a BIT can be extremely costly for governments." (Emphasis added.)

These findings are corroborated by the study conducted by Aisbett, Busse, & Nunnenkamp, "Bilateral Investment Treaties Do Work; Until They Don't", *Kiel Institute for the World Economy, Working Paper* (No 2021, 2016). Allee and Peinhardt differentiate between effects on foreign direct investment flows from both bilateral investment treaty partner countries and non-partner countries. Their data set consists of a panel of 83 host state and 93 source states covering the period 1980-2010. Their results are in large part similar to the findings of Allee and Peinhardt in that they demonstrate "a negative, statistically and economically significant impact of [an ICSID] claim on bilateral FDI [foreign direct investment] flows." (p 11)

Moreover, Aisbett, Nussee and Nunnenkamp find at p 16 that flows of foreign direct investment from bilateral investment treaty-partners decreases more strongly following a dispute than those from unprotected sources. The authors state at p 16 that "the magnitudes of the observed effects suggest that investors no longer perceive BITs [bilateral investment treaties] provide them any meaningful protection in a host country after a claim has been filed against it".

In conclusion on this first risk, the relatively scarce econometric data available makes clear that there is a negative correlation between a state being sued in ICSID proceedings and inflows of foreign direct investment. The commencement of ICSID proceedings largely functions as a negative signal to the investment community and creates uncertainty as to the state's commitment to adhere to the standards of protection enshrined in the state's investment agreements. Significantly, a state which eventually loses an ICSID dispute will, based on the empirical studies, experience as a consequence even greater losses in inward foreign direct investment.

The second risk that arises for a state sued pursuant to an international investment agreement is that there will subsequently be a number of other claims brought against the state, even where there are entirely different bases for the claims being brought (in legal terms, differing causes of action).[3]

Consider, for example, the following:

(1) **Algeria**: Algeria has been the Respondent state in 8 ICSID cases. These cases were instituted in 2003, 2005, 2009, 2012, 2012, 2012, 2017, and 2017. In these proceedings four out of the eight cases had a different legal basis and concerned different economic sectors.

(2) **Albania**: Albania has been the Respondent state in seven ICSID cases. These cases were instituted in 1995, 2007, 2011, 2011, 2013, 2014, and 2015. All of these cases had a different legal basis and concerned different economic sectors.

(3) **Croatia**: Croatia has been the Respondent state in eight ICSID cases. These cases were instituted in 2004, 2007, 2012, 2013, 2013, 2015, 2016, and 2016. All of the cases had a different legal basis and concerned different economic sectors.

(4) **Czech Republic**: The Czech Republic has been the Respondent state in 35 ICSID cases. These cases were instituted in 1999, 2000, 2001, 2002, 2004, 2005, 2005, 2005, 2005, 2005, 2006, 2007, 2007, 2008, 2008, 2008, 2008, 2009, 2009, 2013, 2013, 2013, 2013, 2013, 2013, 2013, 2014, 2014, 2014, 2014, 2015, 2015, 2015, 2016, and 2017. In these proceedings 15 out of the 35 cases had a different legal basis and concerned different economic sectors.

(5) **Hungary**: Hungary has been the Respondent state in 14 ICSID cases. The cases were instituted in 2001, 2003, 2004, 2007, 2007, 2009, 2011, 2012, 2012, 2012, 2013, 2013, 2014, and 2016. In these proceedings, nine out of the 14 cases had a different legal basis and concerned different economic sectors.

(6) **Republic of Korea**: South Korea has been the Respondent state in three ICSID cases. These cases were instituted in 2012, 2015, and 2015. All of these cases had a different legal basis and concerned different economic sectors.

(7) **Moldova**: Moldova has been the Respondent state in 11 ICSID cases. These cases were instituted in 1994, 2004, 2005, 2009, 2010, 2011, 2012, 2012, 2014, 2016, and 2016. In these proceedings five out of the 11 cases had a different legal basis and concerned different economic sectors.

(8) **Poland**: Poland has been the Respondent state in 24 ICSID cases. These cases were instituted in 1994, 1996, 1996, 1996, 1998, 2003, 2004, 2006, 2006, 2008, 2008, 2009, 2009, 2010, 2011, 2012, 2013, 2013, 2013, 2014, 2014, 2014, 2014, and 2015. In these proceedings, 17 out of the 24 cases had a different legal basis and concerned different economic sectors.

(9) **Romania:** Romania has been the Respondent in 13 ICSID cases. These cases were instituted in 2001, 2005, 2005, 2006, 2006, 2007, 2010, 2010, 2012, 2014, 2014, 2015, and 2016. All of these cases had a different legal basis and concerned different economic sectors (insurance, mining, electricity generation, beverage production, steel industry, press distribution company, agricultural machinery and equipment enterprise, ammonia manufacturing and processing plant, oil refinery and petrochemical complex, frozen-food warehousing business, duty free and other retail services, food production facilities, and financial services).

(10) **Vietnam**: Vietnam has been the Respondent state in five ICSID cases. These cases were instituted in 2004, 2010, 2011, 2013, and 2014. All of these cases had a different legal basis and concerned different economic sectors.

Biog box
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While it is difficult to draw concrete conclusions from this examination, what does however appear to be the case is that in a number of these examples involving a state which is sued in ICSID a number of subsequent cases are often instituted consecutively within a period of a few years of each other. The reasons for this may vary, but once an investor sues the state in ICSID then, *inter alia*, it highlights to other foreign investors in the state the viability and advantages of investment arbitration which may feed through into their planning and decision-making processes when considering the future of their investments. This may lead investors in practice to re-structure the chain of companies involved in holding their investments to ensure they have the necessary standing under favourable international investment agreements to bring a case against the state when they consider it necessary.

In sum, given the very significant potential risks outlined above in terms of loss of flows of foreign direct investment and the risk of increased investment claims being brought against the state where it has consented to this by International Investment Agreements, then a prudent and imperative course of action for the state when faced with a cogent claim which has reasonable grounds for success would be to settle the claims. This imperative to settle may even be more important when a state is faced with its first investment case. ■

1 United Nations Conference on Trade and Development (UNCTAD) numbers, accessible on http://investmentpolicyhub.unctad.org/IIA

2 UNCTAD statistics, accessed on 27 November 2017 and available at: http://investmentpolicyhub.unctad.org/ISDS/FilterByRulesAndInstitution

3 It has certainly been the case that a state will often be repeatedly sued by investors who have a similar cause of action; that is, where those suing the state operate in the same sector and are challenging the same regulatory action or law by the state. Examples here include Spain which is a Respondent state in 36 investor-state disputes the majority of which relate to Spanish reform of its electricity sector and the withdrawal of benefits to investors in its renewable energy sector; and Italy which is a Respondent in 9 investment arbitration cases, the majority of which concern the Italian government's decision to cut tariff incentives for certain solar power projects.

Further Reading:

- Remedies in investment treaty arbitration and WTO law: complementary systems? (2017) 6 JIBFL 356.
- The European Union, investment treaty arbitration and some possible consequences of Brexit (2017) 2 JIBFL 98.
- When international financial institutions arbitrate: what law governs international investment arbitration (2012) 10 JIBFL 612.
- LexisPSL: Financial Services: The legal reasoning of ICSID tribunals – an empirical analysis.