Investor-State Dispute Settlement Mechanism: The Quest for a Workable Roadmap

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International Investment Arbitration, diplomatic protection, Bilateral Investment Treaty, ICSID, denunciation, NAFTA, AUSFTA, appellate mechanism

Abstract
The last decade has witnessed an unprecedented increase in the use of investor-State arbitration, highlighting numerous shortcomings of the existing investor-State dispute settlement system. The legitimacy of the International Investment regime has been under severe criticism due to the growing discontent amongst the investors as well as the host States. The increased litigation has led to both the process and the outcome being questioned and has undermined the growth of harmonious relationships between foreign investors and host States. The object of this paper is to explore a workable roadmap for the investor-State dispute settlement mechanism by tracing the evolution of the existing system and by analysing the dispute settlement mechanism in major international investment agreements. Furthermore, it highlights the causes and the possible consequences of the denunciation of Bilateral Investment Treaties (‘BITs’) and the International Centre for Settlement of Investment Disputes (‘ICSID’) by host nations, which have been plagued by a myriad of investment suits. The authors suggest the need for doing away with highly protective investor-State dispute settlement mechanisms (‘ISDSMs’) in future investment agreements and recommend the need for designing an appellate mechanism for bringing consistency and predictability to the system.

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Any attempt to follow the developments of international economic law ‘is like trying to describe a landscape while looking out the window of a moving train – events tend to move faster than one can describe them’.


I. Introduction

On January 24, 2012, Venezuela communicated to the World Bank its ‘irreversible denunciation’ of the International Centre for Settlement of Investment Disputes (‘ICSID’). It is widely believed that a recent ICC award against Petroleos de Venezuela S.A, a Venezuelan oil company, in favour of an Exxon Mobil subsidiary was the driving force behind Venezuela’s decision to withdraw from the ICSID.

The issue brought to light from the above example concerns the establishment of appropriate mechanisms to settle disputes between foreign investors and host governments. Foreign investment plays a key role in the progress and development of a country, in particular those which are less developed. The flow of foreign investment is usually a one way street wherein investment flows from the developed to developing countries, with almost no investment flowing in the opposite direction. However, in the absence of mechanisms to protect such investments, foreign investors are reluctant to employ resources in countries, especially those suffering from legal and political instability. With a view to addressing this concern, several mechanisms have been developed over the last few decades to protect investors and encourage foreign investment.

Hence, this paper aims to explore the evolution and establishment of some of the investor-State dispute settlement mechanisms (‘ISDSMs’) over the years as well as throw light on certain loopholes existing in these mechanisms and make suggestions to rectify the same. Section II deals with the evolution of investor-State dispute settlement mechanisms by delving into the numerous investment agreements and treaties from the past and tracing the growth of investor-State dispute settlement mechanisms, from diplomatic protection to modern Bilateral Investment Treaties (‘BITs’). Furthermore, Section II highlights certain features peculiar to these agreements and treaties. Section III looks at the causes for the shifting trend of reversion by nations from highly protective investor-State dispute settlement mechanisms to the Calvo doctrine, ie resolving disputes by applying local laws. Section IV highlights the causes of denunciation from BITs and the Convention on the Settlement of Investment Disputes (‘ICSID Convention’). It analyses the consequences of these denunciations under the customary principles of international law and the interpretation of sunset clauses present in most BITs. Section V and VI deal with the North American Free Trade Agreement (‘NAFTA’) and the Australia-United States Free Trade Agreement (‘AUSFTA’), respectively and the common criticisms made against the dispute settlement mechanisms contained in these two major free trade agreements. These sections discuss in detail the NAFTA experience from sweet to sour and throw light upon the new trend adopted by developed nations by doing away with the highly protective ISDSM provision and reverting to local remedies and State-to-State dispute settlement in AUSFTA. In Section VII, the authors strongly recommend the need for designing an appellate mechanism in order to improve the efficiency and transparency of investment dispute settlement mechanisms. Section VIII consists of the authors’ conclusions.

II. The Evolution of the Investor-State Dispute Settlement Mechanism: From Diplomatic Protection to BITs and More

The protection of foreign property has occupied a position at the core of public international law, since its very inception. Disputes between States resulting from alleged violations of a national’s property rights can be traced to the end of the 18th century. Post colonisation, the European empires ensured their business interests in foreign lands through either imperial

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4 Compare the statement of the US Secretary of State John Adams in 1796: ‘There is no principle of the law of nations more firmly established than that which entitles the property of strangers within the jurisdiction of another country in friendship with their own to the protection of its sovereign by all efforts in his power. This common rule of intercourse between all civilized nations has, between
submissions or the establishment of capitulation systems. In the absence of these, the foreign investment disputes were international disputes between the home State and the host State based on diplomatic protection⁷, which was the traditional means of obtaining redress for foreign investors harmed by breaches of international law. A protection of this kind could mean ‘consular action, negotiation, mediation, judicial and arbitral proceedings, reprisals, retorsion, severance of diplomatic relations, economic pressure and, the final resort, the use of force.’⁸ In the Mavrommatis case the Permanent Court of International Justice noted: ‘It is an elementary principle of international law that a State is entitled to protect its subjects, when injured by acts contrary to international law committed by another State, from whom they have been unable to obtain satisfaction through the ordinary channels.’ ⁷

However, the law on foreign investment, despite being one of the oldest, was characterised by the International Court of Justice as a relatively underdeveloped area of international law.⁹ Indeed, the body of jurisprudence of the international arbitral tribunals under the BITs was small at that time and so were the number of BITs in existence. Moreover, these arbitrations were mainly State-to-State rather than investor-State arbitrations.

The first investor-State arbitration under a BIT took place in 1987,⁹ and the reports suggest that prior to this most of the investment disputes that referred to the international tribunals were either brought in pursuance to contractual agreements by the private parties or were State-to-State arbitrations. Two related developments were involved in the evolution of investor-State dispute resolution from diplomatic protection: the establishment of forums for direct claims and the growth in the use of treaties (breaches of which could be pursued either in those forums or sometimes in domestic courts).¹⁰ Earlier, the investment issue had been covered by the Treaty of Friendship, Commerce and Navigation (‘FCN Treaty’) between developed and developing countries.¹¹ However, there were no provisions which dealt with the settlement of investment disputes, since the Latin countries, which formed a majority of the developing countries at that time, insisted on following the Calvo Doctrine.¹² Furthermore, foreign investors doubted whether developing countries had enough unbiased experts to settle investment disputes.¹³

After World War II, the developed nations began utilising new types of treaties. These treaties included the Investment Guarantee Agreement (‘IGA’) and Investment Protection Agreement (‘IPA’). While the former dealt with investment insurance and subrogation, the latter dealt with investment protection. The FCN Treaty, IGA and IPA are collectively known as a Bilateral Investment Treaty.¹⁴

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⁹ ILC, ‘First Report on Diplomatic Protection’ (2000) UN Doc A/CN.4/506, 15; see also FS Dunn, The Protection of Nationals: A Study in the Application of International Law (1st, John Hopkins Press 1932), [‘Diplomatic protection] embraces generally all cases of official representation by one Government on behalf of its citizens or their property interests within the jurisdiction of another, for the purpose, either of preventing some threatened injury in violation of international law, or of obtaining redress for such injuries after they have been sustained.’
¹⁰ Mavrommatis Palestine Concessions (Greece v UK) PCIJ Rep Series A No 2, 12.
¹¹ The ICJ made the following remarks in 1970 about the state of development of the law of foreign investment in the Barcelona traction case: ‘Considering the important developments of the last half-century, the growth of foreign investments and the expansion of international activities of corporations, in particular of holding companies, which are often multinational, and considering the way in which the economic interests of states have proliferated, it may at first sight appear surprising that the evolution of the law has not gone further and that no generally accepted rules in the matter have crystallized on the international plane.’ Barcelona Traction, Light and Power Co (Belgium v Spain) [1970] ICJ Rep 3, 46-7.
¹⁵ The Calvo Doctrine, named after the Argentine scholar Carlos Calvo who is generally deemed to be the creator of this doctrine, is based upon the idea of equal treatment between nationals and foreigners and thus proposed that foreign investment disputes had to be resolved through national adjudication and by applying national law. See DR Shea, The Calvo Clause: A Problem of Inter-American and International Law and Diplomacy (University of Minnesota Press 1955) 19 et seq; A Freeman, ‘Recent Aspects of the Calvo Doctrine and the Challenge to International Law’ (1946) 40 American Journal of International Law 121, 132-133; see also I Henkin, Basic Documents Supplement to International Law: Cases and Materials (3rd edn, West Pub. Co, 1993) 685.
The emergence of BITs was primarily a response to the uncertainties and inadequacies of the customary international law of State responsibility for injuries to aliens and their property.\textsuperscript{15} The first ever BIT was signed between Germany and Pakistan in 1959 and contains provisions for non-discrimination, full protection and security, compensation on expropriation, free transfer of capital, and State-to-State dispute settlement by the ICJ with mutual agreement of the disputing parties, or failing that, by an arbitral tribunal on request of either of the disputing party.\textsuperscript{16} By 2010, the universe of the international investment agreements included 2,807 BITs.\textsuperscript{17}

Today, investment arbitration's newfound importance can be credited to the changes in dynamics and mechanisms of foreign investment dispute resolution. Previously, investment disputes were settled by State to State action. But in most cases, home representation was difficult to secure as host States were only receptive to politically symbolic or economically important disputes.\textsuperscript{18}

In the beginning the developing countries viewed international arbitration with scepticism, although to the foreign investors it seemed a neutral and reliable forum.\textsuperscript{19} Investor-State arbitration started with the inclusion of international arbitration clauses in the investor-State agreements. Only 31 investor-State disputes were reported before the advent of the International Centre for Settlement of Investment Disputes in 1961.\textsuperscript{20}

Discussions on the Convention on the Settlement of Investment Disputes between States and Nationals of Other States in the year 1965 gave recognition to the right of a State to give consent in a treaty to arbitrate future disputes and also recognised that an investor could accept such consent by submitting a claim to international treaty arbitration, thereby replacing investor-State arbitration under an investor-State agreement with arbitration under a treaty.\textsuperscript{21} This move was an innovative one as the foreign investors directing supra-national arbitration against a State do not have privity of contract in such treaties.\textsuperscript{22} The first investment treaty containing such an investor-State arbitration clause was the Indonesia-Netherland BIT concluded in 1968, although it conditioned such arbitration on State consent in the event of an investment dispute.\textsuperscript{23}

From the early 1960s, developed countries started advocating the creation of the ICSID, an institution created to settle disputes between host nations and foreign investors through arbitration and conciliation. During negotiations, developing nations agreed to a limited transfer of their sovereignty by submitting investor-State disputes to the ICSID for resolution. According to Professor Chen Huiping, the developing countries however maintained ‘four safety valves’ in order to retain some control in the resolution of disputes.\textsuperscript{24}

The first safety valve was the exhaustion of local remedies. According to this, all local administrative and judicial remedies available to the contracting parties were to be exhausted before submitting the dispute to the jurisdiction of the ICSID.\textsuperscript{25} The second safety valve was consent to arbitration on a case by case basis. Being a party to the ICSID Convention does not mean unconditional consent to ICSID arbitration. According to the ICSID Convention, the contracting parties must consent in writing to submitting the dispute to the ICSID.\textsuperscript{26}

The third safety valve was that the law of the host country was to be the governing law. Developing countries wanted disputes to be settled on the basis of their domestic laws whereas developed nations wanted disputes settled on the basis of their international law.

\textsuperscript{15} ibid 41-48.
\textsuperscript{16} Treaty for Protection of Investment (West Germany-Pakistan) 25 November 1959 457 UNTS 23.
\textsuperscript{19} See generally Newcombe (n 14).
\textsuperscript{22} Wegen (20) 44.
\textsuperscript{23} ibid.
\textsuperscript{26} ICSID Convention, art 25(1).
international law. The ICSID reached a compromise between both schools of thought by permitting the contracting parties to choose the governing law by agreement. In the absence of any agreement, the law of the host country was to be applied, along with any rules of international law as may be applicable.27

The fourth safety valve was State sovereignty and national security. This means that even after acceding to the ICSID Convention, a nation can at any time decide the class or classes of cases it wishes to submit to the jurisdiction of ICSID.28 For example, in 1978, Papua New Guinea notified ICSID that it would submit only those disputes which are elementary to the investment itself.29

These four safety valves were aimed at protecting the developing nations from being easily sued by foreign investors. This is one of the major reasons why only 24 cases were submitted to the ICSID during the first 25 years of its existence.30 However, developing countries seemed to have drastically changed their stance by the end of the 1980s by deviating from the Calvo Doctrine, giving up the ‘four safety valves’, and accepting the highly protective dispute settlement provisions in their BITs. Three elements contributed to this dramatic shift. First, the perception developed that being a party to the ICSID Convention was a method of increasing mutual confidence, which in turn increased the inflow of capital into the developing country.31 Second, during this period, the US started to sign protection agreements (‘IPAs’) instead of guarantee agreements (‘IGAs’) as per its newly developed Model BIT and countries which wished to sign BITs with the US had no option but to accept the high standards. And third, developing countries started considering signing BITs with developed countries as a means of improving their domestic legal environment for foreign investment.32

However, in recent times, the number of cases against developing nations by foreign investors and the amount of compensation paid by the host government has increased manifold and consequently the developing countries have started implementing a more conformist approach with respect to investor-State dispute settlement mechanism.

III. Reversion from Highly Protective Investor-State Dispute Settlement Mechanism to Calvo

In late April 2007, the member States of the Alternativa Bolivariana para la América Latina y El Caribe (‘ALBA’)33, namely Bolivia, Venezuela, Nicaragua and Cuba, proclaimed their intention to withdraw from the International Monetary Fund and the World Bank.34 The Republic of Bolivia35 was the first State to implement this resolution, and submitted a notice of denunciation of the Washington Convention on the Settlement of Investment Disputes between States and nationals of other States (the ‘ICSID Convention’) on May 2, 2007.36 Even if Bolivia became the first State ever to withdraw from the ICSID Convention, its move hardly came as a shock to those following developments in South America.37

This move was followed by the subsequent withdrawal from the Convention of Ecuador, on July 6, 2009.38 However, the

27 ICSID Convention, art 42(1).
28 ICSID Convention, art 25(4).
31 Huiping (n 24) 2.
32 Schreuer (n 13) 6.
33 The Bolivarian Alliance for the Peoples of Our America (ALBA) is an international cooperation organisation based on the concept of economic, political and social integration between the countries of the Caribbean and Latin America. It is an attempt at regional economic integration based on a vision of social welfare and mutual economic aid, rather than trade liberalisation as with free trade agreements. This initiative includes Venezuela, Bolivia, Cuba, Nicaragua, and Dominica. Antigua and Barbuda, Ecuador and Saint Vincent and the Grenadines formally joined ALBA on 24 June 2009. ‘Portal ALBA-TCP’ (Alianza Bolivariana) <http://www.alianzabolivariana.org/> accessed 14 August 2012.
38 The Government of the Republic of Ecuador signed the ICSID Convention on January 15, 1986 and deposited its instrument of ratification on the same date. The Convention entered into force for Ecuador on February 14, 1986. On July 6, 2009, the depositary received a written notice of Ecuador’s denunciation of the Convention. In accordance with Article 71 of the Convention, the denunciation took effect six months after the receipt of Ecuador’s notice, ie, on January 7, 2010.
most recent development is the ‘written notice of denunciation from the Convention by the República Bolivariana de Venezuela’. The Ministry of Foreign Affairs explained that its denunciation was based on the position that international arbitration of oil and gas disputes is inconsistent with the Venezuelan constitution of 1999.39

In the past few years, these unprecedented withdrawals have highlighted several legal problems regarding withdrawal from the ICSID Convention and its effects, particularly with respect to consent to ICSID arbitration expressed in a Bilateral Investment Treaty.40 These withdrawals can be regarded together with the emergence of the Banco Del Sur41 as a further move towards establishing what can be qualified as a ‘New Regional Economic Order’ for the Americas.42

In addition, a few developing countries have also begun considering withdrawing from other existing investment agreements with ISDSM provisions. For instance, although Ecuador has withdrawn its consent for ICSID claims, this did not in itself preclude other arbitral claims because Ecuador has consented to the UN Commission on International Trade Law (‘UNCITRAL’) and other commercial arbitration in its BIT.43 In 2008, Ecuador terminated nine BITs - with Cuba, the Dominican Republic, El Salvador, Guatemala, Honduras, Nicaragua, Paraguay, Romania and Uruguay. Other denounced BITs include those between El Salvador and Nicaragua, and the Netherlands and the Bolivarian Republic of Venezuela.44

In 2010, Ecuador’s Constitutional Court declared arbitration provisions of six more BITs (China, Finland, Germany, the UK, Venezuela and the US) to be inconsistent with the country’s Constitution. It is possible that Ecuador will take action to terminate these (and possibly other) BITs.45 Most recently, India, after being rattled by threats from foreign investors, has sought treaty reversions to deal with corporate suits.46 These recent practices indicate an increasing trend among developing countries to tighten or narrow ICSID jurisdiction and to take conservative positions toward ISDSMs.

The reason for this new trend by developing countries, of reverting to traditional, conservative attitudes by withdrawing from highly protective ISDSMs, is not limited to the flood of arbitration cases and the large awards against these countries. It is also because the experiences of the past three decades have shown that the expected benefits from the ICSID and the ISDSMs did not materialise. The developing countries’ denunciation of the ICSID, or the abolition of the ISDSM provisions in investment treaties, is premised around the realisation that the proposition offered for signing a highly protective US-type ISDSM did not materialise. The developing countries’ denunciation of the ICSID, or the abolition of the ISDSM provisions in investment treaties, is premised around the realisation that the proposition offered for signing a highly protective US-type ISDSM, or consenting to ICSID jurisdiction with the expectation of high flow of investment from the investor-State to the host in investment treaties, is premised around the realisation that the proposition offered for signing a highly protective US-type ISDSM, or consenting to ICSID jurisdiction with the expectation of high flow of investment from the investor-State to the host countries, was a flawed one.47 These withdrawals by the developing countries reflect their reversion to the traditional Calvo Doctrine,48 which gives exclusive jurisdiction to the national courts of the host countries over investment disputes.

IV. Consequences of Denunciation of BITs and the ICSID Convention

The aforementioned countries’ denunciations from the ICSID and several Bilateral Investment Treaties raise novel and

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41 Banco Sur is a lending organisation established on 26 September 2009 by Argentina, Brazil, Paraguay, Uruguay, Ecuador, Bolivia and Venezuela with an initial capital of US$20 billion.


44 Jijón-Letort (n 43).

45 ibid.


48 Henkin (n 12) 685.
complex legal issues of systemic importance for the international investment regime.\textsuperscript{49} While some countries no longer view ICSID as the preferred means of resolving investor-State disputes, the existing legal framework – depending on its interpretation – may make it difficult for these countries to abrogate it.\textsuperscript{50} To minimise uncertainties and to comprehend the possible consequences of such denunciations, some tentative conclusions about the interface between international investment law and general international law in the specific area of withdrawal from treaties have to be drawn.\textsuperscript{51}

Under the customary rules of international law, as codified in the Vienna Convention on the Law of Treaties of May 22, 1969 and the Vienna Convention on the Law of Treaties between States and international organisations or between international organizations of March 21, 1986 (‘the Vienna Convention’), a State has a right to withdraw from a treaty when that treaty so provides. Under Article 54 of the Vienna Convention, ‘the termination of a treaty or the withdrawal of a party may take place: (a) in conformity with the provisions of the treaty; or (b) at any time by consent of all the parties after consultation with the contracting States and contracting organizations.’ In the absence of a provision, a treaty ‘is not subject to denunciation or withdrawal unless: (a) it is established that the parties intended to admit the possibility of denunciation or withdrawal; or (b) a right of denunciation or withdrawal may be implied by the nature of the treaty’.\textsuperscript{52}

A denunciation provision in the ICSID Convention States: ‘Any Contracting State may denounce this Convention by written notice to the depositary of this Convention. The denunciation shall take effect six months after receipt of such notice.’\textsuperscript{53} Therefore, the critical question is not whether a Contracting State may withdraw from the ICSID Convention, but what consequences are attached to such withdrawals. The specific legal implication of such withdrawal by a State has so far hardly been addressed in the literature and thus remains to a large extent ‘an unexplored legal territory’.\textsuperscript{54}

Most of the international investment agreements include an offer of ICSID arbitration. The importance of the ICSID derives from the fact that, unlike other international arbitral awards, ICSID awards do not require domestic enforcement procedures in accordance with the New York Convention\textsuperscript{55} and, therefore, cannot be refused enforcement on, \textit{inter alia}, public policy grounds. An ICSID award is equivalent to ‘a final judgment of a court’ in all of the ICSID Contracting States, and therefore is directly executable.\textsuperscript{56}

The State must be a party to the ICSID Convention for an investor to start ICSID arbitration against a State. However, membership in itself is not sufficient for a State to be sued under ICSID. ICSID’s jurisdiction over investor-State disputes rests on the notion of ‘consent’, which generally is a cornerstone of international dispute settlement involving States.\textsuperscript{57} In addition to ICSID membership, consent to ICSID arbitration must have been given by the State in a contract with a foreign investor, a national law of the State concerned, or an international investment agreement (‘IIA’) such as a Bilateral Investment Treaty.

In the past decade, the majority of ICSID disputes have been initiated on the basis of IIAs or BITs. According to the leading school of thought, the relevant clause in a BIT represents a unilateral offer of consent, which can be accepted by the other disputing party, ie an investor. Investors typically express their consent by filing a request for arbitration. In other words, for a case to be taken up by the Centre, the ICSID Convention requires the written consent of both disputing parties. The consent is ‘perfected’ and can no longer be revoked unilaterally, when this happens.\textsuperscript{58}

However, the issue of contradictory interpretation of Article 72 of the Convention will have considerable repercussions on the future investment landscape in both the developing and developed countries, since room is left for contradictory interpretations as to whether the denouncing State remains bound by the Convention only in relation to disputes initiated

\textsuperscript{50} ibid.
\textsuperscript{51} Tzanakopoulos (n 40).
\textsuperscript{53} ICSID Convention, art 71.
\textsuperscript{55} New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (adopted 10 June 1958, entered into force 7 June 1959) 7 ILM 1046.
\textsuperscript{56} ICSID Convention, art 54(1).
\textsuperscript{57} ‘No State can, without its consent, be compelled to submit its disputes…to arbitration, or any other kind of pacific settlement.’ Status of Eastern Carelia Case (Finland v USSR) (Advisory Opinion) PCIJ Rep Series B No 5, para 33.
\textsuperscript{58} ICSID Convention, art 25(1); see Schreuer (n 21) 7.
before the denunciation, or if they are also bound in future disputes, as long as the State's consent to ICSID arbitration continues to exist in that country's BITs.59

This latter reading effectively means that a State must separately terminate all of its BITs that provide for ICSID arbitration to prevent future ICSID claims, in addition to denunciating the ICSID Convention itself. Also, even post termination, the BITs retain their force due to the ‘survival clauses’, ie up to 20 years after the termination, thereby exposing the country to ICSID proceedings. Thus, the way out of this interpretative puzzle will have far-reaching consequences for the system of international investment dispute settlement.

V. NAFTA: From Sweet to Sour

The North American Free Trade Agreement (‘NAFTA’) was entered into by the United States of America, Canada and Mexico in 1992 with the objective of promoting opportunities for investment as well as providing a suitable investor protection mechanism.60 Chapter 11 of NAFTA has been a subject of controversy, especially with respect to its provisions surrounding expropriation and investor-State dispute settlement mechanisms, which have affected several sovereign and regulatory matters.61

Opponents of NAFTA allege that the provisions of Chapter 11 create new rights for corporations and investors, which has the effect of allowing them to dodge the rule of law, thereby compromising public interest.62 One of the main reasons for invoking Chapter 11 was to thwart Mexico from expropriating foreign investment. During the early 1900s, in a bid to boost Mexican economy, the government started encouraging foreign investment. Though the Mexican economy flourished, it resulted in more than half the country’s wealth being owned by foreign nationals. As a result, it gave rise to anti foreign sentiments, which led to the Mexican Revolution in 1910. In 1917, a new Constitution was adopted by the Revolutionaries, which aimed at putting several restrictions on foreign investments by expropriating and nationalising foreign-owned assets.63

In 1974, the developing nations, by virtue of attaining a majority in the UN General Assembly, enacted the Charter of Economic Rights and Duties of States (‘CERDS’).64 Article 2 of CERDS essentially restored the Calvo Doctrine, which was vehemently opposed by the developed nations.65 Therefore, NAFTA was enacted under the US’s BIT programme, the objective of which was to nullify CERDS by creating a system of treaties with other nations which embrace a ‘prompt, adequate and effective’ standard of compensation.66 Article 1105(1) of NAFTA States: ‘[e]ach Party shall accord to investments of investors of another Party treatment in accordance with international law, including fair and equitable treatment and full protection and security.’67

Chapter 11 of NAFTA contains protective clauses enabling a party to force a foreign government to undergo international arbitral proceedings under the rules of ICSID or UNCITRAL,68 or enabling an investor to bring a claim to an international tribunal, thereby circumventing the domestic courts of the host State69 and requiring that the applicable law would be NAFTA, as interpreted and applied under international law.70 Bringing a claim under Chapter 11 is advantageous as it reduces the cost of litigation, reduces the possibility of a jury that would be sensitive to the needs of the host nation,71 allows

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59 Tietje (n 42) 7; see also Tzanakopoulos (n 40).
61 Article 1110(1) of NAFTA states that no Party signatory may nationalise or expropriate an investor's assets except for public purpose, on a non discriminatory basis, in accordance with the due process of domestic as well as international law and on payment of compensation.
63 See generally DR Loritz, ‘Corporate Predators Attack Environmental Regulations: It’s Time to Arbitrate Claims Filed under NAFTA’s Chapter 11’ (2000) 22 Loyola of Los Angeles International and Comparative Law Review 536. The Mexican government justified its actions by taking the defence of the Calvo Doctrine, under which all foreign-owned assets could be expropriated in accordance with domestic law and policy.
65 Article 2 states that if a dispute arises over any foreign investment matter, the dispute shall be decided according to national/domestic judicial or arbitral procedures.
67 NAFTA, art 1105(1).
68 ibid art 1120(1).
69 ibid art 1121.
70 ibid art 1131(1).
each party to appoint its own arbitrator to present its position, and provides for the application of international law and not domestic law to the dispute.\textsuperscript{72} Chapter 11 also allows persons to sue national governments.\textsuperscript{73}

Though Chapter 11 provides security against direct and indirect expropriation, it does not define either term but does require disputes to be decided under international law. Expropriation, according to international law, is defined as a ‘compulsory transfer of rights.’\textsuperscript{74} Indirect expropriation is defined as ‘having effect equal to expropriation’ or ‘all measures, whose effect is, directly or indirectly, to dispossess investors.’\textsuperscript{75}

Chapter 11 of NAFTA has had its fair share of critics, especially with regard to the weakened sovereignty of member nations, high rate of taxes as well as the ad hoc nature of the tribunals and lack of lucidity in NAFTA proceedings.\textsuperscript{76}

One of the biggest criticisms directed towards NAFTA is that it gives foreign investors greater rights than it does to domestic investors.\textsuperscript{77} NAFTA enables foreign investors to bring an action against the government of a member State, whereas due to sovereign immunity such rights are not extended to domestic investors. Moreover, foreign investors also have a right of action over claims which are not available to domestic investors.\textsuperscript{78}

A case which highlights the overtly pro foreign investor stance of Chapter 11 is \textit{Loewen Group Inc v US},\textsuperscript{79} in which the tribunal implied that even decisions of state Supreme Courts and the US Supreme Court can be challenged under the NAFTA investor dispute mechanism, even though no such analogous right was extended to domestic investors. However, this case was ultimately dismissed.\textsuperscript{80}

Nevertheless, it is felt that doing away with Chapter 11 would not resolve the issue, since without it, foreign investors would not have remedy available to them in case of a breach by a local government\textsuperscript{81} and the initial favouritism accorded to foreign investors would only be replaced by favouritism given to domestic investors.

Another major criticism of Chapter 11 is that the provisions enable investors to directly bring an action against State governments so as to discourage them from enacting otherwise legitimate laws. The prospect of litigating costly NAFTA suits might deter governments from passing any law that might result in a suit under NAFTA.\textsuperscript{82} Since the governments are vulnerable to lawsuits, NAFTA’s investment dispute mechanism could cost taxpayers billions of dollars. This can be further substantiated by the example of the case of \textit{Metalclad v Mexico},\textsuperscript{83} in which the government of Mexico was held liable to pay damages of $15.6 million, a burden which ultimately was shifted to the tax payers.\textsuperscript{84}

The dispute resolution mechanism of NAFTA’s Chapter 11 is considered to be another major loophole. Critics contend that the ad hoc nature of the tribunals and the absence of any appeals mechanism lead to discrepancy and instability.\textsuperscript{85} Under Chapter 11, investors submit to the rules of arbitration of ICSID or UNCITRAL. The rulings laid down by these tribunals

\textsuperscript{72} ibid 123.


\textsuperscript{77} ibid 1067; article 1110 of NAFTA states that ‘[n]o Party may directly or indirectly nationalize or expropriate an investment of an investor of another Party in its territory or take a measure tantamount to nationalization or expropriation of such an investment’.


\textsuperscript{79} Loewen Group Inc v United States (2003) ICSID Case No ARB(AF)/98/3, 42 ILM 811.

\textsuperscript{80} The tribunal found that the trial judge had failed in his duty in taking control of the trial by allowing the jury to be exposed to constant appeals to prejudice on part of the claimant’s counsel and witnesses and termed the trial as a ‘disgrace’. See LJ Dhooge, ‘The Loewen Group v United States: Punitive Damages and the Foreign Investment Provisions of the North American Free Trade Agreement’ (2004) 19 Conn. J Intrnl L 495, 498-499.

\textsuperscript{81} Anderson (n 76) 1071.


\textsuperscript{83} Metalclad Corporation v United Mexican States (2001) ICSID Case No ARB(AF)/97/1, 40 ILM 56.

\textsuperscript{84} ibid 112-126.

are only binding on the parties to the case and do not have any precedential value. Therefore, there is always a strong possibility that the rulings laid down by different tribunals might vary, since different proceedings will be adjudicated by different arbitrators.

Lack of transparency is another concern as, under Chapter 11, parties must submit to arbitration through either ICSID or UNCITRAL, under which the award cannot be published without the consent of the parties. This lack of transparency is a cause for concern, particularly where NAFTA disputes involve policies that have a direct bearing on the public. This contention can be supported by the case of Methanex Corp v US, which dealt with a California ban on a certain gasoline additive produced by the investor, who alleged that it was a violation of the minimum standard of treatment under NAFTA and hence constituted an expropriation. It was held that, as it involved the health and safety of all citizens, they too should be allowed to participate in the judicial process.

Thus, Chapter 11 of NAFTA highlights the need to maintain a fair balance between the interests of foreign as well as domestic investors, as well as coming up with a dispute mechanism that reduces the potential for ambiguity and establishes a more secure arbitral system.

VI. AUSFTA: Lessons from the Past

In February 2004, the United States and Australia concluded negotiations that led to signing of the Australia-United States Free Trade Agreement (AUSFTA). The agreement gave birth to considerable publicity and debate, particularly in Australia, where both major political sides made it a campaign issue.

AUSFTA was to be of considerable significance as it sought to eliminate 99.5% of all tariffs on trade between the two countries, making it a landmark of sorts in the history of bilateral treaty structure. It was also anticipated that Australia stood to gain over $6 billion from AUSFTA. Nevertheless, AUSFTA has had its fair share of detractors. It was feared that by joining AUSFTA, Australia intended to forego the multilateral framework and deal exclusively within a bilateral structure.

Previously, developed countries would not enter into BITs with each other, and even in cases where they did, there would be no provision for investor-State dispute settlement mechanisms. It was believed that developed countries with stable legal machinery did not require a dispute settlement mechanism for international investment. The domestic laws and practices of the host State were considered to be adequate for the protection of both the investor and the host country.

The US was keen to include its modified ISDSM in AUSFTA as well. However, the proposal faced opposition from Australia for two reasons. First, judging by the numerous NAFTA investment cases, if investor-State provisions were to be included in AUSFTA, there would be a strong possibility of numerous suits being initiated against the Australian government by American investors as well. In addition, these NAFTA investment cases had resulted in widespread public resistance to

86 NAFTA, art 1136: An award made by a tribunal shall have no binding force except between the disputing parties and in respect of the particular case.
88 Anderson (n 76) 1080.
90 ibid 1-2.
91 Anderson (n 76) 1081.
94 J Bhagwati and R Garnaut, ‘Say No to This Free Trade Deal’ The Australian (Sydney, 11 July 2003).
The exclusion of the ISDSM in AUSFTA has been termed by western scholars as ‘blowback’. ‘Blowback’ is a term used to signify that a State reaps what it sows, even if the State is oblivious as to what it has sown. Thus, the US ended up lobbying for a mechanism that met with considerable condemnation not only abroad but also within the American political framework. The exclusion of ISDSM in AUSFTA was aimed at avoiding international arbitration cases between the two countries as mutual investment is very active.99

Chapter 11 of AUSFTA specifically deals with investment. Though it does not contain any specific provisions dealing with investor-State disputes (unlike many BITs signed with developing countries) when compared to the Canada-US FTA, it provides for a more detailed mechanism in dealing with such disputes. Article 11.16.1 provides that:

1. If a Party considers that there has been a change in circumstances affecting the settlement of disputes on matters within the scope of this Chapter and that, in light of such change, the Parties should consider allowing an investor of a Party to submit to arbitration with the other Party a claim regarding a matter within the scope of this Chapter, the Party may request consultations with the other Party on the subject, including the development of procedures that may be appropriate. On such a request, the Parties shall promptly enter into consultations with a view towards allowing such a claim and establishing such procedures.

2. For greater certainty, nothing in this Article prevents a Party from raising any matter arising under this Chapter pursuant to the procedures set out in Chapter 21 (Institutional Arrangements and Dispute Settlement). Nor does anything in this Article prevent an investor of a Party from submitting to arbitration a claim against the other Party to the extent permitted under that Party’s law.

The Australian Department for Foreign Affairs and Trade justifies the exclusion of a dispute settlement mechanism in AUSFTA by stating that it is an acknowledgment of the well developed legal systems of both nations, which provide adequate protection to private investors against the host government.100

This attitude appears to evince a clear preference by investors to local remedies before resorting to international arbitration. Thus, Article 11.16.2 of AUSFTA allows foreign investors to submit disputes to general commercial arbitration, provided that it is permitted under the host country’s laws.102

According to the interpretations given by both governments, the key aspect of dispute settlement in AUSFTA is that Article 11.16.2 also allows any of the contracting parties, be it the host State or the home government of the foreign investor, to refer the dispute to State-to-State dispute settlement. Some experts are of the opinion that the mechanism is a means for protecting foreign investors, which is almost completely dependent on diplomatic protection. However, this is no guarantee as the State may overlook the breach for the purpose of maintaining friendly diplomatic relations.105

Though AUSFTA does not include the NAFTA-style ISDSMs, it is possible for foreign investors to bring a claim against the host State through international arbitration. Both governments consented in the AUSFTA treaty that in case of changes in the economic or legal circumstances of both parties, the parties could consider establishing a discrete procedure to hear claims brought about by investors. Article 11.16 requires certain conditions to be fulfilled before such a claim can be brought

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97 ibid 153.
98 ibid.
99 A Capling, ‘All the Way with the USA: Australia, the U.S., and Free Trade’ (UNSW Press 2005) 71. The US is the biggest contributor of investment to Australia, while Australia is the eighth biggest contributor of investment to the US.
101 Capling and Nossal (n 96) 152.
102 Article 11.16.2 of AUSFTA: ‘[N]or does anything in this Article prevent an investor of a Party from submitting to arbitration a claim against the other Party to the extent permitted under that Party’s law.’
103 Article 11.16.2 provides that ‘nothing in this Article prevents a Party from raising any matter arising under this Chapter pursuant to the procedures set out in Chapter 21’. Chapter 21 deals with ‘Institutional Arrangements and Dispute Settlement’, which provides for State-to-State dispute settlement.
104 Dodge (n 10) 27.
105 ibid 26-27.
about. Firstly, 'there has been a change in circumstances affecting the settlement of disputes on matters within the scope of this Chapter'. Though Australia limits the term 'change in circumstances' to changes in the economic and legal sphere, AUSFTA itself has no such restriction.  

Secondly, 'in light of such change, the parties should consider allowing an investor of a party to submit to arbitration.' However, in the absence of any objective criteria, it is possible that the parties may allow for arbitration only on political or economic considerations. Thirdly, 'on such a request, the Parties shall promptly enter into consultations with a view towards allowing such a claim and establishing such procedures.' Hence, both parties have discretion with respect to establishing arbitration procedures. Fourthly, the arbitration procedures should be established by both parties. Nevertheless, Article 11.16 is silent as to what procedures should be established in arbitration.

Thus, it can be said that AUSFTA adopts a different approach to that of NAFTA. While under the latter, it is the investors who refer investment disputes, the former provides for an aggrieved investor, who has exhausted all remedies in the local courts of the other country, to persuade its own government to take up the issue and proceed further. Moreover, a dispute can be referred for arbitration only when there has been a change in circumstances affecting such disputes. However, with the possibility of a 'change in circumstances' being unlikely, the circumstances under which one of the governments will refer a matter to arbitration are reduced.

While the general opinion in Australia was that AUSFTA increases the scope for future challenges by foreign investors against the host nation, experts in the US considered the absence of an investor-State dispute mechanism to be a step backwards from previous FTAs and BITs. Furthermore, US policies, which accord more protection to its own State interests and less to that of foreign investors, appear unlikely to change soon, especially as the party currently holding the majority in the US, the Democrats, is of the belief that foreign investors should not be given any protection greater to that of US investors.

VII. Need for Designing an Appellate Mechanism

Criticism directed towards certain structural features of NAFTA and AUSFTA have highlighted the need for an appropriate appellate mechanism. Arbitration proceedings, which are not subject to appeal on the merits, were intended as a cost and time saving measure. Nevertheless, a risk associated with such a mechanism is that it may lead to the rendering of a flawed or incompatible award, on a similar set of facts. Even though an appellate system was initially considered to be inconsistent with a cost effective arbitration system, some scholars have recommended the establishment of an appeals mechanism for investment arbitration after the NAFTA cases showed many inconsistent arbitration decisions.

A proposal by the ICSID Secretariat, perhaps drawing inspiration from the World Trade Organization (WTO) appellate review system, outlined the merits of establishing an appellate framework within the ICSID system. However, any such attempts are bound to face certain hurdles as Article 53 of the ICSID Convention clearly lays down that ICSID awards 'shall be binding on the parties and shall not be subject to any appeal.' Thus, the proposal failed to garner support.

107 See (n 102).
108 Huiping (n 24) 30.
109 AUSFTA, art 11.16.1.
110 Capling and Nossal (n 96) 160.
111 ibid 161.
112 ibid.
113 'US Democrats Unveil Trade Policy, Days before Key Deadline' (Bridges Weekly Trade News Digest, 28 March 2007).
116 117
The US Trade Act of 2002, allows the Executive Branch to present trade agreements to the Congress for approval by a yes-or-no vote by a simple majority,\(^{118}\) has laid the foundation for the signing of several recent US Free Trade Agreements. It has also laid down certain objectives regarding foreign investment,\(^{119}\) including an appellate body to adjudicate investment disputes arising from free trade agreements.\(^{120}\) As a result, the US included the following clause in its free trade agreements with Chile, Singapore, Morocco and its 2004 Model BIT with respect to an appellate mechanism:\(^{121}\)

> Within three years after the date of entry into force of this Agreement, the Parties shall consider whether to establish a bilateral appellate body or similar mechanism to review awards rendered under Article…in arbitrations commenced after they establish the appellate body or similar mechanism.\(^{122}\)

A key factor with respect to an appellate mechanism upon which governments and investors are likely to disagree is that of the standard of review. The standard could range from high or low standards of review, to a de novo review of the proceedings.\(^{123}\) The ICSID Annullment Committee usually annuls an arbitral award only in cases where ‘the Tribunal has manifestly exceeded its powers.’\(^{124}\) According to the UNCITRAL Model Law, Article 34 lays down that an award can be annulled if ‘[T]he award deals with a dispute not contemplated by or not falling within the terms of the submission to arbitration, or contains decisions on matters beyond the scope of the submission to arbitration.’ The ICSID Secretariat’s Discussion Paper proposed that other than an error in law or any of the five grounds mentioned in Article 52 of the ICSID Convention, an arbitral award may further be challenged in cases where there is a critical error of fact.\(^{125}\) However, this approach has been criticised, as reviewing an award on the grounds of an error of fact would call for reviewing the award de novo, an approach that should be avoided as far as possible.\(^{126}\)

Other issues that need to be ironed out between governments and investors in order to pave the way for an appellate mechanism are those relating to choice of law, correlation between the appellate body and the domestic court review system as well as dealing with multiple agreements.\(^{127}\)

One of the main reasons for calls for an appellate mechanism is to bring about a degree of consistency in judicial pronouncements.\(^{128}\) The cases of *CME v Czech Republic*\(^{129}\) and *Lauder v Czech Republic*,\(^{130}\) both based on similar facts but contradictory decisions, have attracted a great deal of attention.

The purpose of consistency in arbitral awards is to ensure consistency in interpretations given to differently worded clauses of different agreements, so that tribunals do not reach conflicting conclusions on facts of a similar nature. However, one needs to tread carefully in this regard. For example, the OECD Investment Committee on substantive obligations in investment agreements divulged that a country’s objective with regard to interpretations of similar clauses in their investment agreements may fluctuate in some aspects.\(^{131}\) Therefore, the intent of signatories to international agreements must also be taken into consideration when ensuring consistency in international legal principles.

\(^{118}\) ‘This trade authority, formerly known as ‘fast-track’, allows the Executive Branch to present trade agreements to the Congress for approval by a yes-or-no vote by a simple majority.’ B Legum, ‘The Introduction of an Appellate Mechanism: The US Trade Act of 2002’ in E Gaillard and Y Banifatemi (eds), *Annulment of ICSID Awards* (International Arbitration Institute 2004).

\(^{119}\) 19 US Code § 3802(b)(5).

\(^{120}\) ‘…providing for an appellate body or similar mechanism to provide coherence to the interpretations of investment provisions in trade agreements…’ Legum (n 118); 19 US Code § 3802(b)(3)(G)(iv).


\(^{124}\) ICSID Convention, art 52.

\(^{125}\) See (n 116).

\(^{126}\) Gantz (n 123).

\(^{127}\) ibid.


\(^{131}\) Yannaca-Small (n 121).
In recent years, there have been growing instances of domestic courts interfering in the enforcement of arbitral awards and in the process,\textsuperscript{132} defeating the very purpose of international arbitration. This issue could be easily addressed by the establishment of an appellate body, as there would be qualified tribunals to review arbitral awards on the basis of internationally accepted standards, instead of review by local courts, which are vulnerable to government influences. Instead of setting up separate ad hoc appeals mechanisms under separate agreements, setting up one single, institutionalized appeals mechanism, consisting of rules and procedures accepted by all would perhaps be more prudent.\textsuperscript{133} If an appellate mechanism adjudicating upon investment disputes does become a reality, it could very well have legal ramifications, as decisions issued by these tribunals may establish precedents. Countries which have not established such appeals machinery could be influenced through political and diplomatic mediums to do so.\textsuperscript{134}

Therefore, an appropriately executed appellate mechanism would undoubtedly go on to benefit both governments and private investors. However, some sort of agreement needs to be reached first amongst governments, investors and other interested parties with respect to structural and procedural concerns, in order to avoid the various legal and practical impediments inherent in setting up such appellate tribunals.

\textbf{VIII. Investor-State Dispute Settlement Mechanism: Delineating A Workable Roadmap for the Future}

The last few decades has seen a considerable rise in the number of investor-State disputes. However, a series of deficiencies in the existing investor-State dispute settlement mechanisms threatens to uproot the very purpose for which these mechanisms were brought into place. These dispute resolution mechanisms have ended up becoming a costly and wants-based process that leaves both investors and governments wanting for more.\textsuperscript{135}

ISDSMs have become one of the most contentious issues for both developed and developing countries. Recent trends with respect to ISDSMs have indicated an increased standard of protection by State governments as well as a consensus between developed and developing countries on a desire to convert ISDSMs to a State-to-State dispute mechanism. Nevertheless, some scholars are of the opinion that with the existence of NAFTA and ICSID, as well as over 2000 BITs which provide for investment arbitration, ISDSMs are here to stay.\textsuperscript{136}

However, if ISDSMs are not covered in future trade agreements, it would perhaps be more convenient for both developed and developing countries to conclude such agreements under either the WTO or the UN Conference on Trade and Development (‘UNCTAD’). The use of local remedies or State-to-State dispute settlement mechanisms as laid down under AUSFTA would also be satisfactory to both developed and developing countries.

The practicality of setting up an appellate mechanism should also not be overlooked. Setting up a single institutional appellate body would result in a reduction in the possibility of reaching conflicting conclusions, thereby increasing transparency and consistency. The present WTO Dispute Settlement Body as well as the Appellate Body could also be applied to investment disputes.

Thus, the insistence by developed countries of negotiating investment agreements and treaties with highly protective ISDSM provisions has precluded the host States from agreeing on a global normative framework on investment under the WTO. The stand adopted by investor nations is indicative of sheer hypocrisy and hampers the much needed global harmony in investment regime. The authors highly oppose the protective ISDSMs in future investment agreements and recommend an AUSFTA style mechanism acceptable to both developed and developing nations which prioritises local remedies and State-to-State dispute settlement.

\textsuperscript{132} For example Saipem S.p.A. v The People’s Republic of Bangladesh (2009) ICSID Case No ARB/05/7. In this case, the Bangladeshi courts denied Saipem, an Italian company, the benefits of an award made in its favour by an ICC tribunal.

\textsuperscript{133} Yannaca-Small (n 121). The ICSID, recognising the issue of multiple appeals mechanisms under multiple agreements as a serious cause for concern due to its potential for causing disintegration and ambiguity in law, proposed the creation of an optional ICSID Appeals Facility, to be established and operated under a set of Appeals Facility Rules.

\textsuperscript{134} ibid.
