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## **Investor-State Dispute Settlement: A Reality Check**

*A Report by the Scholl Chair in International Business at CSIS*

### **Executive Summary**

Investor-State Dispute Settlement (ISDS), a provision in Bilateral Investment Treaties (BITs) and other international investment agreements that allows investors to enter arbitration with states over treaty breaches, has become controversial in the United States and our negotiating partners. Critics, including some governments, have argued that ISDS is unnecessary while others insist it is illegitimate as public policy.

This report is an empirical review of ISDS, based on the record of disputes under existing investment treaties. The key findings are as follows:

- Over 90 percent of the nearly 2400 BITs in force have operated without a single investor claim of a treaty breach.
- There has been an increase in the number of disputes filed in the past ten years. Overall, the rise in disputes has been proportional to the rise in outward foreign capital stock. There are more disputes, but there are also more investors and more capital invested abroad.
- Investors from large capital-exporting economies are active users of ISDS. European countries are a party to over 1200 BITs and account for 47 percent of global FDI stock; in the past decade European investors have filed more than half of investment arbitration claims. Similarly, the United States is responsible for 24 percent of outward FDI stock; U.S. investors have filed 22 percent of ISDS claims.
- Many disputes arise in economic sectors characterized by high levels of state intervention. About 40 percent of filed ISDS claims are in oil, gas, mining, and power generation sectors which often feature prominent state involvement.
- Disputes are also most frequent in states with weak legal institutions. Argentina (53 claims) and Venezuela (36 claims) are the leading respondent states.
- About a third of ISDS cases are settled in advance of a ruling. For disputes which end in an arbitral decision, states win about twice as often as investors. When investors do prevail, awards are a small fraction of the initial claim—on average, less than ten cents on the dollar.

Investors generally recognize that ISDS is expensive and time-consuming, on par with complex civil litigation. While arbitration offers neutrality and finality, investors are typically aware of the low likelihood of prevailing and the risk that filing a claim presents to their future operations.

Many of the criticisms of ISDS are overblown. Some claim that ISDS gives investors “special rights,” yet most treaty protections are identical to universal civil rights accorded most citizens. Further, critics exaggerate the notion that investors “sue to overturn regulations;” BITs explicitly limit awards to monetary damages. Finally, conflating ISDS with “big corporations” ignores the fact that the majority of U.S. investors who have filed investment arbitration claims are firms with fewer than 500 employees.

Treaty-based investment protection represents a major advance in the fair treatment of aliens and the peaceful resolution of disputes. Given the alternatives, withdrawing from investment treaties—the logical conclusion of the critics’ position—would likely have negative consequences for economic growth and the rule of law.

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## Introduction

Bilateral Investment Treaties (BITs) are international agreements between two economies that set forth binding rules on each government's treatment of investment from the other economy. The basic rules are similar to core principles of U.S. law and policy and are an established and recognized component of international investment law which require governments to: not discriminate in favor of home-country or third country investors; afford investors' investments fair and equitable treatment and full protection and security; provide full and prompt, adequate, and effective compensation in the event of an expropriation; allow investors to move their capital into and out of the country; not impose performance requirements (such as local content requirements); and allow for neutral arbitration of disputes in the event that treaty obligations are breached. Nearly 2400 BITs and similar agreements are in force worldwide,<sup>1</sup> including investment chapters in free trade agreements and plurilateral arrangements like the Energy Charter Treaty.

The operation and effect of dispute settlement arrangements for investment agreements are different from trade agreements. A typical trade dispute affects the treatment of a class of goods or services originating from a party, usually not the product or service of a single firm, although such claims have been filed. Most trade agreements contain state-to-state dispute settlement procedures and the remedy for a trade dispute is usually prospective, and often requires the losing party to modify the terms of trade (e.g., laws, regulations, and/or tariff rate) for the good in question.

However, BITs provide protections that extend to a firm, and a breach of treaty obligations affects an individual enterprise. BITs allow a foreign investor to bring a claim in arbitration directly against the host state for a breach in the terms of an agreement, against the government responsible for the breach—thus, “investor-state dispute settlement,” or ISDS. For investment disputes, the remedy is retrospective, typically in the form of compensation to make an investor whole following a breach of the agreement — ISDS arbitrators cannot require a state to change its laws and regulations.

Since trade and investment agreements are debated and ratified by signatory governments in keeping with their procedures for ratification, ISDS provisions in such agreements are expressions of national policy in the same ways as any other statutes, regulations, or other measures approved by governments.

## Challenges to the Legitimacy of BITs

As the number of disputes filed by investors has increased over the past 10-15 years, so has the controversy surrounding the inclusion of ISDS in trade agreements and investment treaties. Recent criticisms of BITs and ISDS have led some governments to reexamine their policies towards foreign investors with a few questioning whether investment agreements with ISDS are necessary, or in the interest of host states. For instance, Indonesia and South Africa, both large capital importers, but also emerging regional capital exporters, have announced high-profile decisions stating their intent to allow existing investment agreements containing ISDS to expire, arguing that domestic laws and regulations related to investment have evolved to the point where existing ISDS provisions are now irrelevant.<sup>2</sup> In addition, Ecuador and Venezuela have withdrawn officially from the Convention on the Settlement of Investment Disputes between States and Nationals of Other States. Other governments that were once active in negotiating new BITs now take the position that ISDS is not needed in some agreements, based on their opinions about existing domestic legal standards being sufficient to resolve disputes, such as under the 2004 U.S.-Australia Free Trade Agreement, which contains an investment chapter without ISDS. Overall, fewer new BITs are being negotiated, and many major economies—both capital importers and capital exporters—are reconsidering their policies.

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<sup>1</sup> International Investment Agreements Navigator. UNCTAD Investment Policy Hub. <http://investmentpolicyhub.unctad.org/IIA>. Accessed on September 16, 2014.

<sup>2</sup> Ben Bland and Shawn Donnan, “Indonesia to terminate more than 60 bilateral investment treaties,” *Financial Times*, March 24, 2014.

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Beyond changing attitudes among governments, nongovernmental critics of ISDS often place the blame for the controversy on the behavior of investors and argue that ISDS undermines domestic law by prioritizing investor preferences over government policy. Some criticism of ISDS centers on the rising number of disputes. Many NGOs argue that ISDS should be abandoned entirely, and foreign investors should instead rely on host country courts or state-to-state dispute resolution.

These critics argue that BITs and ISDS give foreign investors “special rights” unavailable to domestic firms, and undermine state sovereignty by offering a means for investors to intimidate host governments to change policies arrived at through the democratic process. Nongovernmental organizations often sound the alarm about a “growing” number of ISDS “cases,” and the “enormous” amounts investors are claiming as compensation. Public Citizen’s Lori Wallach argues that BITs “... allow companies to challenge public interest regulations outside of domestic court systems before tribunals of three private sector trade attorneys operating under minimal to no conflict of interest rules. These arbitrators can order governments to pay corporations unlimited taxpayer-funded compensation for having to comply with policies that affect their future expected profits, and with which domestic investors have to comply.”<sup>3</sup> Ska Keller, member of the European Parliament representing the European Greens, wrote that, “[d]emocratic decision-making is forcefully going under the knife through international arbitration. The accused states have only two options: either they can be like others and take back the decisions they have made, or they can pay huge sums in compensation to the investor.”<sup>4</sup> Daniel J. Ikenson of the Cato Institute writes that “ISDS turns national treatment on its head, giving privileges to foreign companies that are not available to domestic companies.”<sup>5</sup>

Some elected officials have responded to these criticisms with proposals to narrow the scope of treaty protections in ways that limit and in some disputes eliminate the ability of investors to file claims. Some proposals along these lines were included in the 2004 U.S. Model BIT. It also appears that the scope of coverage in the CETA agreement is much less than previous European or Canadian BITs as well as the U.S. Model BIT. Nevertheless, Germany’s Economy Minister, Sigmar Gabriel, said in September that his country would not approve the CETA agreement unless its ISDS provisions are scrapped.<sup>6</sup> Other reform ideas include creation of an appellate mechanism, such as the one the U.S. Congress mandated in the U.S.-Central America-Dominican Republic FTA. Still others have proposed mandating alternative dispute resolution mechanisms which would precede initiation of an ISDS filing. If such trends prevail, foreign investors will become wholly dependent upon host country regulators and courts, some of which are in countries with non-democratic governments and poor rule of law track records.

### A Reality Check

Despite these criticisms, our research suggests that BITs represent an important contribution to the rule of law and provide benefits to both capital importers and capital exporters, with nearly 90 percent of all BITs

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<sup>3</sup> Lori Wallach, “Announcement of Flawed 2012 Model BIT Shows Agenda Motivating Obama TPP Talks,” Public Citizen, April 20, 2014, <http://citizen.typepad.com/eyesontrade/2012/04/announcement-of-flawed-investment-rules-show-agenda-motivating-obama-trade-talks.html>

<sup>4</sup> Ska Keller, “Investor-state lawsuits threaten democracy,” TTIP: Beware What Lies Beneath, <http://ttip2014.eu/blog-detail/blog/Ska%20Keller%20Investors%20TTIP.html>, March 26, 2014.

<sup>5</sup> Daniel J. Ikenson, “A Compromise to Advance the Trade Agenda: Purge Negotiations of Investor-State Dispute Settlement,” The Cato Institute, March 4, 2014. <http://www.cato.org/publications/free-trade-bulletin/compromise-advance-trade-agenda-purge-negotiations-investor-state>

<sup>6</sup> “Germany Wants Investment Clause Scrapped in EU-Canada Trade Deal,” Euractiv, September 25, 2014. <http://www.euractiv.com/sections/trade-industry/germany-wants-investment-clause-scrapped-eu-canada-trade-deal-308717>. Accessed on October 20, 2014.

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in force operating without a single dispute.<sup>7</sup> Further, while there are a larger number of disputes now than in the past, the growth in investment disputes is proportionate to the rise in foreign-invested capital stock, which reached US\$ 25 trillion in 2013.<sup>8</sup> These investments are owned by 80,000 multinational enterprises, which in turn own approximately 100,000 affiliates in countries around the world.<sup>9</sup>

There is further evidence that the system is working to the benefit of all parties when looking at the record of completed disputes: about one-third of disputes are settled without arbitrators reaching a decision; in disputes which reach a decision, investors win only about one-third of the time; and awards are generally pennies on the dollar claimed. Finally, ISDS can be used as a last resort for investors given the low winning percentage, high arbitration costs, the current interest in a going concern, risks to relationships with host country governments, and opportunities for future investment.

The network of BITs which has developed over the past half century represents a great achievement in the fair treatment of aliens and the peaceful resolution of disputes between parties. The extension of treaty-based protections lowers risk associated with international investment, which facilitates economic growth and job creation. Access to neutral arbitration helps de-politicize disputes. The success of BITs and ISDS in creating a predictable environment for investors has contributed to prosperity in a number of ways, and should not be abandoned without serious consideration of the alternatives.

### ***Text Box>>>>>>>>>>Do BITs Convey “Special Rights” to Foreign Investors?<<<<<<<<<<<<<<<Text Box***

*The rights provided by BITs and investment chapters of trade agreements--fair and equitable treatment, full protection and security, no expropriation without compensation, and access to impartial arbitration--are consistent with the universal civil rights at the core of most democracies. U.S. BIT provisions are modeled after the takings clause of the U.S. Constitution, which states that “No person shall be ... deprived of ... property, without due process of law; nor shall property be taken for public use, without just compensation.”<sup>10</sup> Similarly, European BIT obligations are consistent with Article I of the Protocol to the European Convention for the Protection of Human Rights and Fundamental Freedoms, which states that “No one shall be deprived of his possessions except in the public interest and subject to the conditions provided by law and by the general principles of international law.”<sup>11</sup> More broadly, Article 17 of the UN’s Universal Declaration of Human Rights says that “Everyone has the right to own property alone as well as in association with others,” and “No one shall be arbitrarily deprived of his property.” Article 10 of the Universal Declaration adds that “Everyone is entitled in full equality to a fair and public hearing by an independent and impartial tribunal, in the determination of his rights ...”<sup>12</sup>*

*U.S. and European BITs guarantee that their foreign investors will receive what are essentially universal rights and protections from treaty partners. Meanwhile, based on the international legal principle of reciprocity, BITs grant the same rights to foreign investors locating in the United States or Europe, including impartial dispute settlement. While some assert that courts in developed economies are sufficiently independent and impartial that ISDS is unnecessary, two recent European studies of ISDS*

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<sup>7</sup> <http://www.italaw.com/cases/by-treaty>. Accessed on July 16, 2014; and International Investment Agreements Navigator. UNCTAD Investment Policy Hub. <http://investmentpolicyhub.unctad.org/IIA>. Accessed on July 16, 2014.

<sup>8</sup> World Investment Report, 2014. United Nations Conference on Trade and Development (UNCTAD), p. 209.

<sup>9</sup> Reisman, W. Michael, “International Investment Arbitration and ADR: Married but Best Living Apart,” *Yale Law Review*, p. 186. [http://www.law.yale.edu/documents/pdf/sela/Reisman\\_reading.pdf](http://www.law.yale.edu/documents/pdf/sela/Reisman_reading.pdf). Accessed on 10/20/2014.

<sup>10</sup> “Fifth Amendment,” U.S. Government Printing Office, p. 1273. <http://www.gpo.gov/fdsys/pkg/GPO-CONAN-1992/pdf/GPO-CONAN-1992-10-6.pdf>. Accessed on October 22, 2014.

<sup>11</sup> European Convention on Human Rights, p. 31. [http://www.echr.coe.int/Documents/Convention\\_ENG.pdf](http://www.echr.coe.int/Documents/Convention_ENG.pdf). Accessed on October 22, 2014.

<sup>12</sup> The Universal Declaration of Human Rights. <http://www.un.org/en/documents/udhr/index.shtml#a10>. Accessed on October 22, 2014.



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since then nearly 2400 BITs and similar instruments have entered into force.<sup>19</sup> The ICSID Convention entered into force in 1966, and today 159 economies are signatories.<sup>20</sup>

For the first time, states made binding commitments concerning the treatment of investors, the breach of which investors could refer directly to a neutral panel before which both parties would have equal legal status. The BIT with neutral arbitration in a rules-based facility gave foreign investors and states both rights and a remedy in one legal instrument, the adoption of which has positively altered the global international investment landscape.

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<sup>19</sup> International Investment Agreements Navigator. UNCTAD Investment Policy Hub.  
<http://investmentpolicyhub.unctad.org/IIA>. Accessed on September 16, 2014.

<sup>20</sup> Member States, International Centre for Settlement of Investment Disputes.  
[https://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=ShowHome&pageName=MemberStates\\_Home](https://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=ShowHome&pageName=MemberStates_Home). Accessed on August 26, 2014.

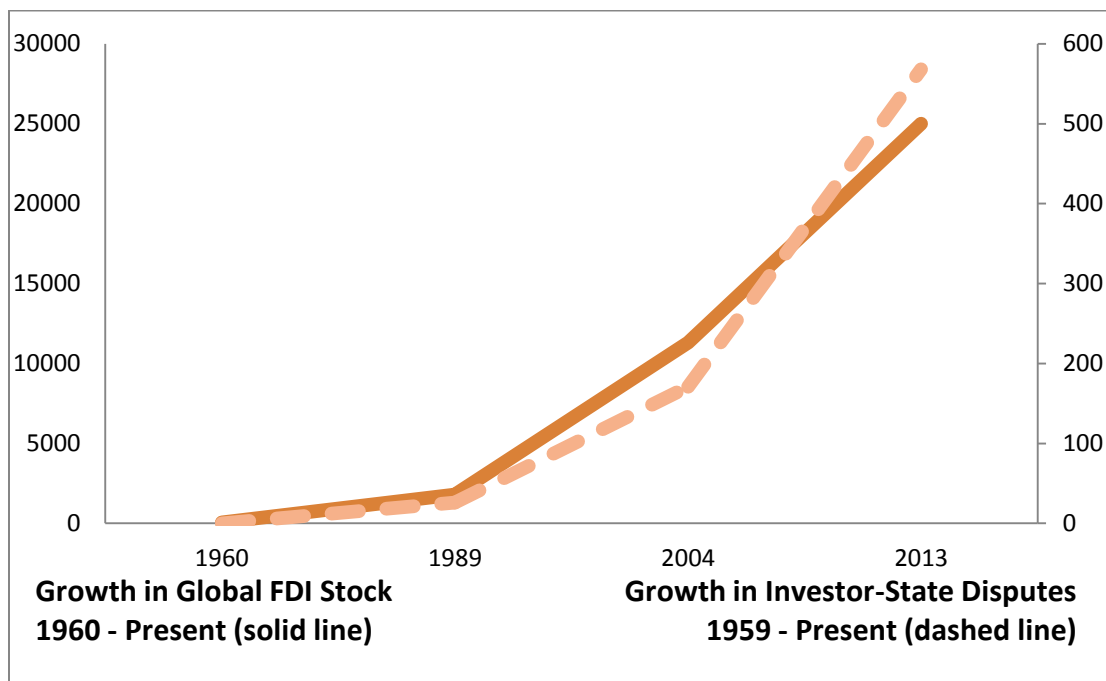
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### ISDS: Analyzing Filed Claims

The number of ISDS arbitrations has risen sharply, especially during the past ten years. According to UNCTAD, about 100 claims were initiated during the fifteen-year period 1987-2002, but from 2003 until 2013, the number of filed claims quadrupled, reaching a total of 568.<sup>21</sup> What are the characteristics of these claims, and what has contributed to the increased utilization of ISDS?

First, it is important to note that the vast majority of BITs and BIT-like agreements have operated throughout their existence without a single claim being filed. Overall, over 90 percent of treaties are functioning with no treaty breaches alleged by investors. Essentially, the host government is acting in a way which accords treatment to foreign investors pursuant to the terms of the treaty in most circumstances. Likewise, it is reasonable to assume in these situations that investors are also operating responsibly within the state's domestic legal system.

The most apparent reason for the rise in ISDS arbitrations is the concurrent rise in the stock of foreign direct investment (FDI). Since the beginning of the BIT era in 1959, the stock of global FDI has expanded at a rate faster than the growth of global economic output. In 1960, the global stock of FDI was just US\$ 60 billion,<sup>22</sup> just 4.4 percent of total world output of US\$1.35 trillion, as measured by the World Bank.<sup>23</sup> As of 2013, the stock of global FDI exceeds US\$25 trillion.<sup>24</sup> In simplest terms, ISDS claims are directly proportional to FDI stock, as long as most of the investment is covered by treaty protections. As shown in the graph below, the growth in ISDS claims and the growth in outward FDI stock follow a similar trend.



<sup>21</sup> World Investment Report, 2014. United Nations Conference on Trade and Development (UNCTAD), p. 124.

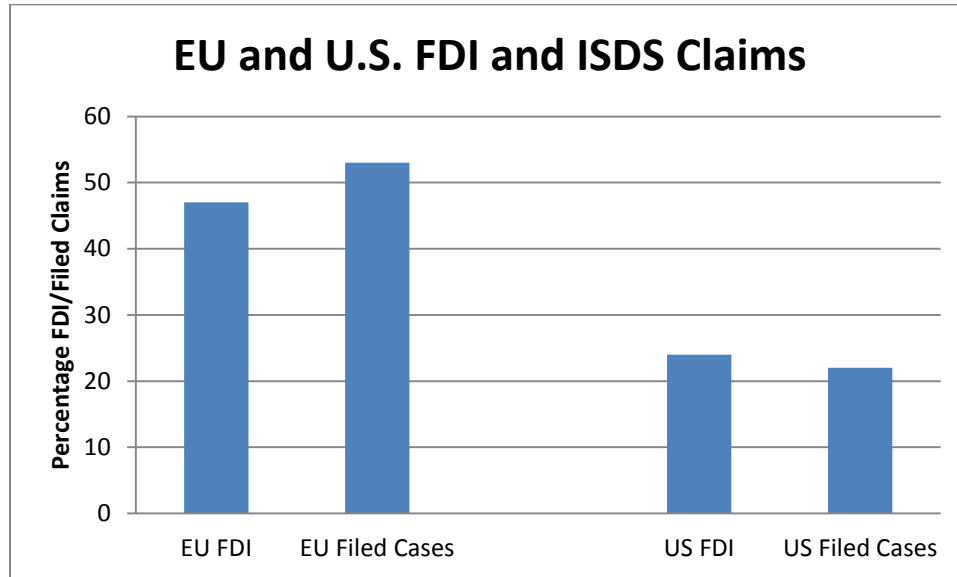
<sup>22</sup> Jones, Geoffrey. "Restoring a Global Economy, 1950-1980," Working Knowledge: The Thinking that Leads. Harvard Business School. August 22, 2005. <http://hbswk.hbs.edu/item/4961.html>. Accessed on October 6, 2014.

<sup>23</sup> GDP Statistics from the World Bank. Knoema. <http://knoema.com/mhrzolg/gdp-statistics-from-the-world-bank#World>. Accessed on October 6, 2014.

<sup>24</sup> World Investment Report, 2014., p. 209.

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Further, and unsurprisingly, investors from economies which are large capital exporters are the most frequent filers of dispute claims. Europe is the source of 46 percent (US\$12 trillion) of global outward FDI stock,<sup>25</sup> and European investors account for just over half (300) of all arbitration claims filed, with the Netherlands (61), the United Kingdom (42), and Germany (39) being the most frequent home states for claimants.<sup>26</sup> Similarly, the United States is the world's largest single country source of outward FDI, providing 24 percent of the capital stock (US\$ 6.4 trillion);<sup>27</sup> U.S. investors are also responsible for the largest individual share of ISDS claims (127, or 22 percent).<sup>28</sup> After the United States, the Netherlands, the United Kingdom, and Germany, the balance of the top ten claimant source states are Canada (26), France (25), Italy (23), Spain (22), Turkey (18), and Switzerland (15).<sup>29</sup>



Next, disputes tend to occur in economic sectors with significant government involvement or those governments view as critical for the national economy. Looking just at ICSID registered claims, over one-quarter of claims have been filed related to foreign investments in the oil, gas, and mining sectors. The electricity, power, and other energy sectors have experienced the second highest proportion of disputes, 13 percent. Construction and finance are the third highest sectors with seven percent of disputes, while water, sanitation, and flood protection tie with the information and communication sectors with six percent of disputes each.

Finally, disputes tend to arise in host economies with poor rule of law records. Argentina has been the most frequent ISDS respondent state (53 ISDS claims, or 9 percent of all claims filed). Venezuela, with 36 claims filed against it, is the second on the list of states facing the largest number of claims.<sup>30</sup> These two countries are ranked 147<sup>th</sup> and 148<sup>th</sup> (out of 148 countries) in the World Economic Forum's Index on

<sup>25</sup> World Investment Report, 2014., p. 209.

<sup>26</sup> "Investor-State Dispute Settlement: An Information Note on the United States and the European Union," UNCTAD IIA Issues Note. No. 2, June 2014. p. 8.

<sup>27</sup> World Investment Report, 2014. p. 210.

<sup>28</sup> "Investor-State Dispute Settlement: An Information Note on the United States and the European Union." p. 8.

<sup>29</sup> "Investor-State Dispute Settlement: An Information Note on the United States and the European Union." p. 9.

<sup>30</sup> "Recent Developments in Investor State Dispute Settlement," UNCTAD IIA Issues Note. No. 1 April 2014. p. 8.



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the Efficiency of Legal Framework in Challenging Regulations.<sup>31</sup> Rounding out the list of most frequent ISDS respondent states are the Czech Republic (28), Egypt (23), Ecuador (22), Canada (22), Mexico (21), Poland (17), the United States (16), and India, Kazakhstan, and Ukraine (15).<sup>32</sup> Transparency International's Corruption Perceptions Index, a commonly used mechanism for rating the governance performance of countries, shows that top claim attractors Argentina, Venezuela, Egypt, Ecuador, Mexico, India, Kazakhstan, and Ukraine all have relatively poor governance indicators.<sup>33</sup>

### Wins, Awards, and Costs: Assessing ISDS Outcomes<sup>34</sup>

Our research indicates that states win the majority of cases. In the cases when investors win, tribunal damage awards are a fraction of the amounts investors claim. Additionally, costs for representation and administration are high and can exceed damages awarded in the event that the claim is successful. Moreover, total costs of arbitration are difficult to predict, because arbitration systems have not established clear rules to allocate costs, and tribunals have addressed cost allocation differently.

Among the facilities for dispute settlement, ICSID, which is the facility of choice for three-fifths of disputes, provides to the public the most information about their resolution. Of the 288 disputes ICSID lists as completed; we could identify the results of 268 of those arbitrations.<sup>35</sup> ISDS arbitration disputes which have reached completion—through either settlement by the parties or decision by the arbitration panel—offer a more granular view of the costs and benefits of ISDS.

ICSID records show that 33 percent of claims (87 of 268) were settled by the parties before the arbitrators reached a decision.<sup>36</sup> For the remaining claims (181), we found that 67 percent of disputes (121) were resolved in favor of the respondent state, while only 33 percent (60) were decided in favor of the investor. The pattern was similar during the early years of ICSID arbitrations (1972-2001), except for a higher rate of settlements. Settlements were reached in 26 of the first 50 disputes, state respondents prevailed in 15, and investors won nine.<sup>37</sup>

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<sup>31</sup> Abbot, Roderick, et.al., p. 11

<sup>32</sup> "Recent Developments in Investor State Dispute Settlement," p. 8.

<sup>33</sup> Corruption Perceptions Index 2013, Transparency International. <http://cpi.transparency.org/cpi2013/results/> Accessed on August 8, 2014. Argentina, score = 36, rank = 106; Venezuela, score = 20, rank = 160; Czech Republic, score = 48, rank = 57; Egypt, score = 32, rank = 114; Ecuador, score = 35, rank = 102; Canada, score = 81, rank = 9; Mexico, score = 34, rank = 106; Poland, score = 60, rank = 38; United States, score = 73, rank = 19; India, score = 36, rank = 94; Kazakhstan, score = 26, rank = 140; Ukraine, score = 25, rank = 144.

<sup>34</sup> The three outcomes, investor win, state win, and settlement are defined as follows for the purposes of this report: investors win when panels awarded them financial compensation; settlements are so indicated in the record; and the remaining outcomes are considered a win for the state.

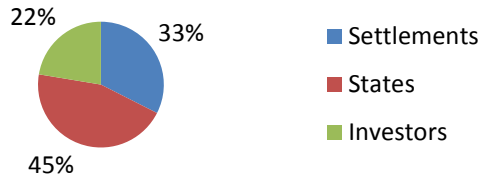
<sup>35</sup> List of Concluded Cases, International Centre for Settlement of Investment Disputes. <https://icsid.worldbank.org/ICSID/FrontServlet?requestType=GenCaseDtIsRH&actionVal=ListConcluded> Accessed August 12, 2014 and ICSID, Investment Treaty Arbitration, <http://www.italaw.com/arbitration-rules/icsid> Accessed August 12, 2014.

<sup>36</sup> See also Reisman p. 187, "Once a dispute has reached the notice-of-arbitration state at ICSID, Eloise Obadia reports that 34% are even then still settled."

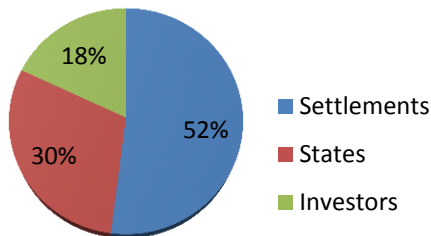
<sup>37</sup> List of Concluded Cases, International Centre for Settlement of Investment Disputes.

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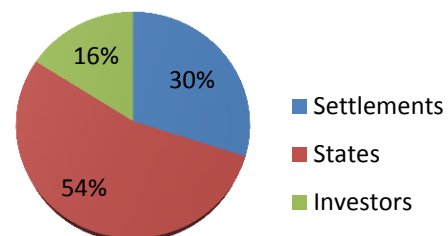
### ICSID ISDS Outcomes (All Claims)



### ICSID ISDS Outcomes (First 50 Claims)



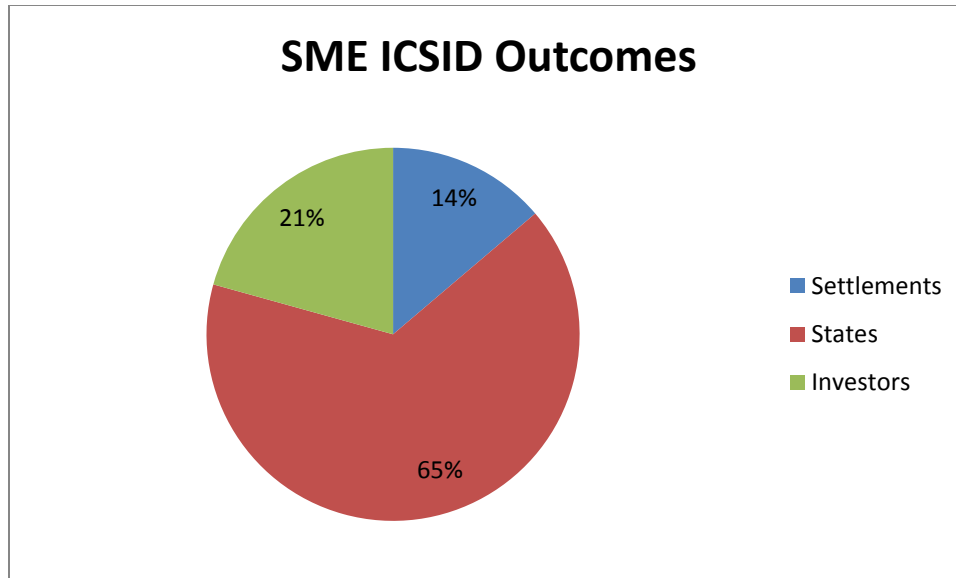
### ICSID ISDS Outcomes (Latest 50 Claims)



An interesting finding relates to the size of the businesses involved in dispute settlement. While foreign investors are popularly thought of as “big business,” the majority of U.S. claimants using the ICSID facility appear to be individuals or enterprises with fewer than 500 employees, designating them as “small and medium-sized enterprises” (SME), according to the U.S. Small Business Administration.<sup>38</sup> In the 105 disputes filed at ICSID by American investors, two-thirds of the participants in the arbitrations were individuals or SMEs. Disputes involving U.S. individuals or SMEs appear to reach a settlement less often than other claims: in 29 completed arbitrations, settlements were reached in only 4, while the state respondent prevailed in 19 disputes (65 percent) and investors won 6.

<sup>38</sup> “Table of Small Business Size Standards,” U.S. Small Business Administration, [http://www.sba.gov/sites/default/files/Size\\_Standards\\_Table.pdf](http://www.sba.gov/sites/default/files/Size_Standards_Table.pdf) Accessed August 5, 2014.

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In terms of damages awarded, the record shows that while the amounts claimed by investors in their arbitration filings can be large, the amounts actually awarded are substantially less. In her initial empirical examination of 52 final ISDS awards, Professor Susan D. Franck found that the average claim was US\$343.5 million, but the average damage award was only US\$ 10.4 million, just three cents on the dollar of the amount originally claimed.<sup>39</sup> Similarly, damage claims in the 51 ICSID-resolved NAFTA Chapter 11 disputes averaged US\$2.9 billion, but the average damage award was US\$66 million—just over two cents on the dollar. A subsequent expanded analysis of claims and awards through January 2012 showed remarkable consistency with these results: the average amount claimed was US\$622 million, and the average award was US\$16.6 million, or just under three cents per dollar claimed.<sup>40</sup> This empirical work indicates that actual awards are proportional and that they represent no threat to “bankrupt” a country.

By comparison, the U.S. Court of Federal Claims awarded in the 2011-2012 case year an average of less than two cents per dollar claimed.<sup>41</sup> Given the high amounts at stake, the high arbitration costs and information asymmetries, ISDS is more akin to forms of adjudication where parties should expect respondents to have a relative advantage. A better analogy for ISDS might therefore be claimant success in whistleblower lawsuits,<sup>42</sup> *qui tam* litigation,<sup>43</sup> *Bivens* lawsuits against government officials for

<sup>39</sup> Franck, Susan D. “Empirically Evaluating Claims about Investment Treaty Arbitration,” *North Carolina Law Review*, Vol. 86. pp. 57-59.

<sup>40</sup> Franck, Susan D. “Using Investor-State Mediation Rules to Promote Conflict Management: An Introductory Guide,” *Washington & Lee Public Legal Studies Research Paper Series*, February 2, 2014. p. 14.

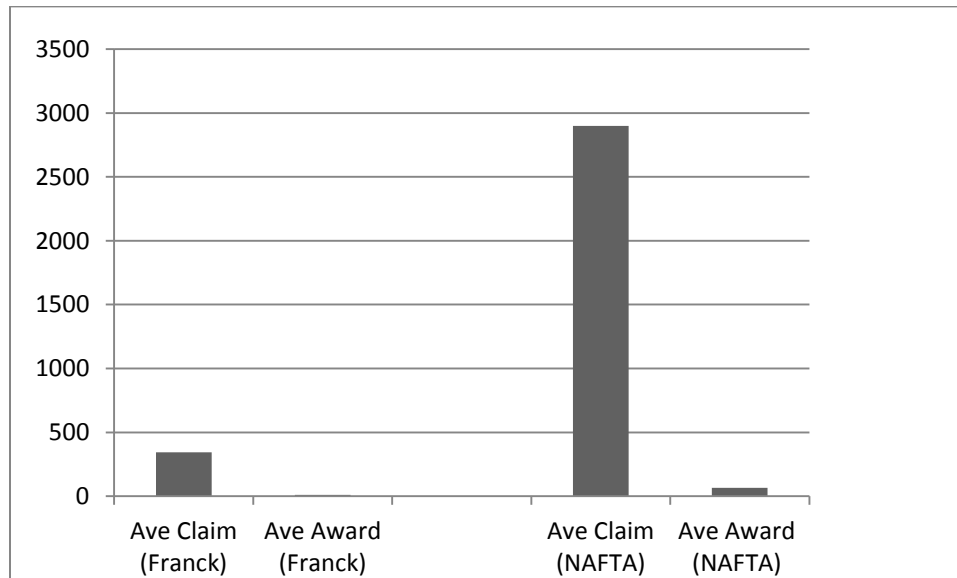
<sup>41</sup> Table G-2B. U.S. Court of Federal Claims – Judgments and Appeals for the 12-Month Period Ending September 30, 2012. <http://www.uscourts.gov/uscourts/Statistics/JudicialBusiness/2012/appendices/G02BSep12.pdf>. Accessed October 6, 2014.

<sup>42</sup> Richard E. Moberly, *Unfulfilled Expectations: An Empirical Analysis of Why Sarbanes-Oxley Whistleblowers Rarely Win*, 49 WM. & MARY L. REV. 65 (2007); Richard E. Moberly, *Sarbanes-Oxley's Whistleblower Provisions: Ten Years Later*, 64 S.C. L. REV. 1 (2012); Nancy M. Modesitt, *Why Whistleblowers Lose: An Empirical and Qualitative Analysis of State Court Cases*, 62 KAN. L. REV. 165 (2013).

<sup>43</sup> David Freeman Engstrom, *Harnessing the Private Attorney General: Evidence from Qui Tam Litigation*, 112 COLUM. L. REV. 1244, 1288-90, 1296, 1299, 1306, 1319-20 (2012).

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violations of citizens' U.S. constitutional rights,<sup>44</sup> citizen complaints against agency action, civil or prisoner rights cases,<sup>45</sup> or medical malpractice litigation.<sup>46</sup> These categories are also somewhat doctrinally similar to ISDS as they involve claims by individuals, claims against a state, claims related to improper regulatory activity, or claims seeking compensation.



Professor Franck's study showed that the range of damage awards was quite large. The smallest award amount was nearly US\$25,000, and the largest was US\$270 million. Tribunals awarded more than \$10 million in four out of 25 arbitration claims in which the investor prevailed. In four other disputes, tribunals awarded between US\$5 and US\$ 10 million, and in the remaining 13, the awards were less than US\$5 million. Tribunals, Franck noted, rarely found in favor of the claimant on all causes of action.<sup>47</sup>

The evidence from completed arbitrations fits with what many commentators have noted about the character of investor-state disputes serving as a "last resort" for investors. Especially in the circumstances of individuals and small firms, investors undertake the large expense and poor odds because the alternative (bankruptcy, or abandoning expropriated assets) is worse. An investor today deciding whether or not to enter ISDS would certainly be aware of the high costs and distant, small benefits of arbitration. But, as we will discuss in the next section, a number of other factors exist that, on balance, deter investors from entering an international investment dispute in the first place.

<sup>44</sup> Alexander A. Reinert, *Measuring the Success of Bivens Litigation and Its Consequences for the Individual Liability Model*, 62 STAN. L. REV. 809, 827-30, 839-46 (2010).

<sup>45</sup> Michael A. Carrier & Daryl Wander, *Citizens Petitions: An Empirical Study*, 34 CARDOZO L. REV. 249, 249 (2012); see also William N. Eskridge, Jr. & Lauren E. Baer, *The Continuum of Deference: Supreme Court Treatment of Agency Statutory Interpretations from Chevron to Hamdan*, 96 GEO. L.J. 1084, 1099 (2008).

<sup>46</sup> Thomas H. Cohen, Bureau of Justice Statistics Bulletin, *Tort Bench and Jury Trials in State Courts, 2005*, 4 (2009), <http://1.usa.gov/1bJn8Mt>; David A. Hyman & Charles Silver, *Medical Malpractice Litigation and Tort Reform: It's the Incentives, Stupid*, 59 VAND. L. REV. 1085, 1126 (2006).

<sup>47</sup> Franck, "Empirically Evaluating Claims about Investment Treaty Arbitration," North Carolina Law Review, Vol. 86, pp. 58-60.



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time. Once a decision to establish operations is taken, the enterprise operates as a “going concern.” Management decision-making focuses on keeping the business operating; in the event of a problem with the host government, the first instinct is to seek to reach a settlement or understanding which allows continuing operations.

A key factor in any decision to litigate or seek arbitration is the scale of an expropriation or other government mistreatment, which could range from a narrowing of business opportunities that reduce current revenue and expected earnings to a taking of the established capital stock along with all prospect of revenue and profits. The first scenario can still be quite serious—a narrowing of business opportunities could make it impossible for the company to recover its initial investment.

The ISDS process begins with formally notifying the host government of the existence and nature of a treaty breach. The next phase, required by almost every BIT, is a “cooling-off” period, from three to six months, to give the disputants an opportunity to resolve the matter through negotiation, consultation or other alternative. During this period, the foreign investor may enlist diplomatic support from his own government, but once a claim proceeds to ICSID arbitration, the investor’s government is precluded from intervening on his behalf (Other systems do not expressly forbid intervention by the investor’s government, but the practice of non-intervention has become customary).

Since the filing of an ISDS claim could be interpreted by the host government as a public accusation of theft, an investor must consider the probability of retaliation. Governments could further limit the scope of the company’s activities, up to and including the possible termination of the company’s access to a given country’s markets. Occidental Petroleum faced this exact scenario in Ecuador. In 2004, Occidental won an ICSID arbitration award of \$75 million against Ecuador as compensation for unpaid VAT refunds. Two years later, Ecuador terminated Occidental’s participation contract, for which an ICSID arbitration panel awarded Occidental an additional \$1.77 billion in compensation in 2012.<sup>53</sup> In another dispute, an investor chose to file an ISDS claim only when it became clear that it faced a choice to either arbitrate or declare bankruptcy for the entire company.

Once the investor submits a claim to arbitration, it remains the driver of the process, but it has multiple gates which must be passed before consideration of the claims on their merits takes place. If, after submitting the claim, the investor withdraws it, the process stops. After filing a claim, the investor must pay a deposit to the arbitral institution to underwrite the costs of the process, and it must nominate an arbitrator. While the state respondent must match these steps, if the investor fails to make this payment or fails to appoint an arbitrator, the process ceases. The final hurdle is convincing the arbitrators that they have jurisdiction to review the merits of the claim. For American companies using ICSID for ISDS arbitration, one in eight fail to pass this last test.

The arbitration process involves not only the main proceedings, but also any challenges to the arbitral award that may be pursued. An arbitration generally takes an average of three and a half years,<sup>54</sup> but some arbitrations have taken longer. Given experience to date, investors can develop a clear understanding of the performance of the system relative to other options. The record of dispute resolution outcomes, damage award values, award amounts, relative costs, time taken to resolve claims, and available legal counsel and arbitrators, would presumably all be factored into an investor’s decision to file a claim.

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<sup>53</sup> “Awards and Decisions”, *Investment Treaty News*, International Institute for Sustainable Development. January 14, 2013. <http://www.iisd.org/itn/2013/01/14/awards-and-decisions-10/>. Accessed on 10/14/2014.

<sup>54</sup> Franck, Susan D., “Using Investor-State Mediation Rules to Promote Conflict Management: An Introductory Guide,” Washington & Lee Public Legal Studies Research Paper Series, February 2, 2014. p. 12.

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Costs for engaging in ISDS are substantial. The OECD has estimated that they average US\$8 million and have occasionally exceeded US\$30 million.<sup>55</sup> In addition, Professor Franck noted that in nearly 40 percent of the awards she studied, tribunals have occasionally required that claimants cover an average of US\$900,000 of respondents' legal fees. Fees charged to pay tribunal and administrative costs average US\$600,000.<sup>56</sup>

Despite the evidence that states tend to prevail in arbitrations, investors continue to file ISDS claims. In many circumstances, investors view ISDS as a better option than a lawsuit in host nation courts or ignoring the treaty violation. Two factors appear to underlie this behavior. ISDS at least provides investors with the semblance of a level playing field, but it also provides them with a final resolution. Host governments cannot draw out the resolution process through appeals to higher courts. In addition, finality and the international publicity associated with the filing of a claim create leverage to negotiate a settlement, an outcome that occurs one-third of the time.

### How governments benefit from dispute arbitration

Over the past 50 years, governments have made a strong policy commitment to BITs with ISDS, one treaty at a time, to achieve today's network of investor protection agreements. The modern BIT has received wide acceptance by states of all sizes and all levels of development primarily because it is a superior instrument versus the alternatives. BITs deliver important, treaty-based assurance to investors regarding decent treatment, and they operate in a peaceful, de-politicized manner that represents a vast improvement over espousal and gunboat diplomacy. While capital exporting states originally endorsed BITs to protect their investors abroad, in today's circumstances every economy is both capital importer and capital exporter. Evidence from arbitration indicates that even G7 members act in ways that amount to a treaty violation, and fair adjudication will mean that states will be both winners and losers in arbitration.

Implementing an international agreement which, once operating, delivers surprising outcomes is not a new event. Consider the early days of the WTO's binding dispute settlement understanding (DSU). Some U.S. elected officials who had championed the DSU after years of frustration with the GATT's non-binding system were shocked to find that U.S. trade law and regulation could violate the GATT, as happened in 1997 when Venezuela prevailed in the "reformulated gasoline" dispute. At the time, surprise translated into calls for reform, which ultimately did not succeed because of the complexity of modifying GATT rules. Now, 20 years after the DSU's founding, member economies have more reasonable expectations about winning and losing, and the WTO's decisions are respected by members.

The BIT network would be much easier to unwind in the name of "reform" than the WTO: bilateral treaties can be renegotiated or abrogated outright, and future negotiating objectives can be changed to emphasize the defensive interests of the state, at the expense of fair treatment for the investor. A lost arbitration does not necessarily mean the treaty or the arbitral panel were flawed; sometimes, states lose arbitrations because they acted in a way that breached their obligations. Our recommendation is that governments engage in a careful review of actual outcomes before implementing "reforms" to the BIT which effectively limit or reverse the protections which encourage firms to invest in their economies.

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<sup>55</sup> "Investor State Dispute Settlement: Public Consultation Document, 16 May – 9 July 2012." Organization for Economic Cooperation and Development. p. 18.

<sup>56</sup> Franck, Susan D., "Empirically Evaluating Claims about Investment Treaty Arbitration," *North Carolina Law Review*, Vol. 86. p. 67-70; and "Rationalizing Costs in Investment Treaty Arbitration," *88 Washington University Law Review* 769, 2011.

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## Appendix 1

### Investment Policy: From “Gunboat Diplomacy” to BITs

If a country’s private outward foreign direct investment and international commercial activity enhances its foreign policy by projecting national power, prestige, economic vitality, and values, then in the often zero-sum world of international relations, the nationalization/expropriation of a foreign investment detracts from the FDI source country’s power, prestige, and economic vitality. Consequently, states have gone to great lengths, including the use of military force, to protect private outward investment and private international commercial interests. The United States is no exception to this pattern.

In 1805, U.S. Naval Agent to the Barbary Powers Captain William Eaton, Navy Lieutenant John Dent, eight U.S. Marines, and approximately 400 European and Arab mercenaries captured the Libyan town of Derna, and the “Shores of Tripoli” entered the Marines Hymn.<sup>57</sup> More importantly, the ruler of Tripoli agreed to end his piracy of American ships and to free American prisoners.<sup>58</sup>

For the first time in its history, the United States had successfully intervened militarily in a foreign country to defend Americans’ private international commercial interests. Over the next 160 years, the U.S. government would order its military forces to intervene in foreign countries 88 times (48% of all U.S. foreign military interventions during the period) to protect Americans’ private international commercial interests. Perhaps the most significant of these deployments was the decades-long stationing of between 3000 and 5000 American soldiers and sailors in China between 1900 and 1941.<sup>59</sup>

The practice was glorified as “Gunboat Diplomacy.” President Theodore Roosevelt talked of “... speaking softly and carrying a big stick ...,” and he formulated the “Roosevelt Corollary” to the Monroe Doctrine that asserted a United States right to intervene militarily in Central American and Caribbean countries to “stabilize” their economies if they could not pay their international debts. However, frequent application of the Roosevelt corollary in the 20<sup>th</sup> century inspired growing anger in Latin American populations, complicating American diplomacy in the region for decades.<sup>60</sup> By 1970, “Gunboat Diplomacy” had been thoroughly discredited.

Parallel to the policy of military intervention in weaker countries to protect the private international commercial (both trade and investment) interests of American citizens, the United States sought to protect such interests in stronger countries through the negotiation of Treaties of Friendship, Commerce, and Navigation. America’s first FCN treaty was concluded in 1778 with France, followed by treaties with the Netherlands (1782), Sweden (1783), and Prussia (1785).<sup>61</sup> In 1794, the Treaty of Amity, Commerce, and Navigation with Great Britain established mixed Anglo-American arbitration commissions to resolve boundary disputes and claims from British and American citizens for property lost during the Revolutionary War. This was the first treaty to provide for mixed commissions to resolve disputes

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<sup>57</sup> “First Barbary War (1801-1805)” [American History Central](http://www.americanhistorycentral.com/entry.php?rec=468).

<http://www.americanhistorycentral.com/entry.php?rec=468>. Accessed on October 24, 2014; and Gawalt, Gerald W. “America and the Barbary Pirates: An International Battle Against an Unconventional Foe” The Thomas Jefferson Papers. The Library of Congress. [http://memory.loc.gov/ammem/collections/jefferson\\_papers/mtjprece.html](http://memory.loc.gov/ammem/collections/jefferson_papers/mtjprece.html). Accessed on October 24, 2014.

<sup>58</sup> “Barbary Wars, 1801-1805 and 1815-1816, Office of the Historian, Department of State, <https://history.state.gov/milestones/1801-1829/barbary-wars>. Accessed on October 24, 2014.

<sup>59</sup> “Timeline of United States Military Operations,” [Wikipedia](http://en.wikipedia.org/wiki/Timeline_of_United_States_military_operations) [http://en.wikipedia.org/wiki/Timeline\\_of\\_United\\_States\\_military\\_operations](http://en.wikipedia.org/wiki/Timeline_of_United_States_military_operations). Accessed on August 1, 2014.

<sup>60</sup> Vandevelde, Kenneth J. “A Brief History of International Investment Agreements,” 12 U.C.-Davis Journal of International Law and Policy 157 (2005) p. 161.

<sup>61</sup> Coyle, John F. “The Treaty of Friendship, Commerce, and Navigation in the Modern Era,” Columbia School of Transactional Law Vol. 51, p. 307.



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between individuals and states. Thus, the Founders of America who negotiated, provided senatorial advice and consent, and ratified this treaty “provided an important blueprint for international investment treaties and the investor-state arbitration system in place today.”<sup>62</sup>

As U.S. outward foreign direct investment increased in the 20<sup>th</sup> century, the United States progressively strengthened property rights protections in FCN treaty texts. Early versions provided basic rights to establish a business and to settle disputes before host nations’ courts. Post World War II versions of the FCN included most of the rights found in today’s BITs, including provisions that the parties would not take foreign investors’ property without due process and prompt and just compensation. In addition, they provided a remedy to expropriation without compensation; state parties could “espouse” claims and submit disputes to the International Court of Justice (ICJ) for resolution.<sup>63</sup>

Despite some successes, the state-to-state process proved both inefficient and unsatisfactory. Positively, state versus state lawsuits before the ICJ established key precedents in international law on the protection of foreign investment, including the concepts of a minimum standard of treatment for foreign investors and the obligation of states to award compensation for private property seized from foreign nationals. On the other hand, the ICJ’s requirement that claimants exhaust all local legal remedies before it would accept a suit and States’ necessarily adopting this standard into their own procedures for “espousing” a case frustrates claimants both in terms of cost and time. Espousal has also been an irritant to bilateral relations, whether states seek to negotiate mutually satisfactory solutions or bring the matter before an international tribunal.<sup>64</sup>

The Cold War era, characterized by its bipolarity and high-risk international competition, but also by significant global foreign direct investment growth, stimulated a game-changing innovation in international relations and international law, the bilateral investment treaty (BIT). The BIT combined the stronger investment rights of the new FCN treaties with a new remedy for treaty violations, investor-state dispute settlement (ISDS). More efficient and less costly for all parties, ISDS has effectively replaced the cumbersome and consistently unsatisfactory state-to-state dispute resolution system while also virtually eliminating the practice of “Gunboat diplomacy” to resolve investment disputes.

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<sup>62</sup> Tietje, Christian and Baetens, Freya, “The Impact of Investor State Dispute Settlement (ISDS) in the Transatlantic Trade and Investment Partnership,” Study prepared for the Ministry of Foreign Trade and Development Cooperation, Ministry of Foreign Affairs, The Netherlands. Reference: MINBUZA-2014.78850. June 24, 2014. p. 18.

<sup>63</sup> Sachs, Wayne “The New U.S. Bilateral Investment Treaties,” 2 Berkeley Journal of International Law 1 Winter 1984. pp. 198-219; Vandeveld, pp. 162-166; and Coyle, pp. 307-308; 313-315.

<sup>64</sup> Vandeveld, pp. 165, 169.