CRUCIAL LEGITIMACY CHALLENGES OF THE CURRENT INVESTOR-STATE DISPUTE SETTLEMENT (ISDS) SYSTEM, AND CURRENT CONSIDERABLE REFORMS

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# I. Introduction

The “Investor-State Dispute Settlement” system refers to the legal mechanisms that allow an investor to have an international investment agreement and enables investors to raise claims against a contracting state, which is different from his host contracting state. More than 3000 IIAs constitute the legal base of the ISDS system and the conclusions of these legal agreements determine the kind of rights an investor has from one territory to the other. ISDS has several standards that protect the rights of investors. Such rights include protection against discrimination, expropriation, capital transfers and “Fair and equitable treatment”. ISDS necessitates that the host government is bound to treat foreign investors equally to the national investors. A foreign investor will have the right to compensation and the investments of foreign investors must be protected from any form of abusive acts. The procedural stages of ISDS begin with an arbitration notice, which is sent by the investors to their host states. After that, the process of selecting the arbitrators begins and each party selects one arbitrator. Thereafter, the proceedings begin and it may last several years and both parties are represented in the team by a group of lawyers. Finally, the amount of compensation is decided and the ISDS procedure comes to an end. However, in recent times, ISDS is facing severe legitimacy challenges and questions have been raised regarding the internal and external functionalities of this system. The legitimacy challenges can be overcome through appropriate reformation strategies. The purpose of this study is to shed light on the legitimacy challenges and the potential reforms of the ISDS system.

# II. Main Body

The concept of legitimacy has been directly linked to the element that has the capability to enhance the path of complying with the law. In terms of international law, it is a critical concept that refers to the degree to which an institution, decision or legal order is acceptable and capable of doing justice to those who are subjected to it. In terms of international law, legitimacy is especially important as it decides the ability of the international organisation to reinforce the decisions in order to achieve the objectives of the organisation. One of the easiest means of conceptualization of legitimacy in terms of international law is by considering procedural justice[[1]](#footnote-2). Procedural justice is basically referred to as the ability of the procedure to make decisions effectively and provide resolution to disputes without engaging in any form of unjust practices. This form of Justice In terms of international law is based on accountability, transparency as well as the ability to provide protection to the procedure. That is during a decision-making process, it provides transparency and allows the participation of the public in the procedure.

On the other hand, Legitimacy can be conceptualised on the basis of subjective justice[[2]](#footnote-3). This refers to the ability to make decisions as well as take legal actions that generate a fair outcome. That is, the procedure is capable of providing protection for human rights, maintaining equity as well as focusing on making decisions without engaging in any form of discriminatory practices. That is the case of making a legal decision which is capable of promoting human rights and Social Justice is considered more legitimate than any other law that perpetuates violation of human rights and engages in distribution and inequality.

According to critical theory, Legitimacy in international law is seen as a combination of social structure and associated power relations. That is, legal organisations and their procedures are considered to meet to the extent of their capability to reflect on the interests of the dominant and powerful power-holding structures and social groups. It basically emphasises the importance of establishing an understanding of the foundation of social and political factors based on which decisions are made. It highlights the role of power and the discriminatory practices that play a major role in shaping the perception revolving around legitimacy. The critical theory considers legitimacy as a debatable concept that keeps on changing based on the power structure as well as the social norms and values residing in a particular society.

On the other hand, according to sociological theory, legitimacy is a result of social practices, norms and values. That is, legal organisations and procedures are seen as just and acceptable based on the ability of the legislation to reflect upon the values and societal practices of the broader range of society. This indicates that this particular theory emphasises the importance of diversified culture and social inclusion in terms of promoting and legitimate structure. Based on this perspective, legitimacy is seen as a combination of the interaction between social groups and other associated structures in society. This particular theory puts a lot of emphasis on the importance of understanding the concept and practices of legal decisions that are made based on the understanding of the social construct.

The importance of understanding Power structures and relations in decision-making is emphasised by the critical theory. In terms of Investor-State Dispute Settlement (ISDS), the critical theory stands for the recognition of the imbalance in power between the states and the investors. This means that the investors have possession of much more resources and hold bargaining power higher than the states. As a result of this, the investors can engage in unfair practices and take advantage of this imbalanced power in a proceeding related to the ISDS system[[3]](#footnote-4). The imbalance in power can weaken the legitimacy of the system by making decisions in favour of the investors. In addition to that, the fact that the system is mostly controlled by private organisations and investors and lack the participation of public figures or organisations, the system can appear to be unfair, non-democratic as well as unaccountable to the public.

The importance of cultural legitimacy which is the main focus of the sociological framework, emphasises the recognition of the system. It perceives the system of ISDS as legitimate in case the decisions are made on the basis of the cultural sectors which include the role of the state, justice as well as maintenance of a fair perception. That is, in case an investor sues the states, it will be seen as a violation of the sovereignty of the state which erodes the legitimacy of the ISDS system[[4]](#footnote-5). Additionally, this particular framework emphasises on the importance of recognises the system and perceiving it as illegitimate in case the legal system does not take into account the Representation of the broader community in terms of the legal system and instead focuses on the social dominance of a small group of a judge who holds the elite position in the society.

The ISDS system originated in the late 1950s and early 1960s. In that particular period, developing nations across the world began to nationalise themselves which led to the Taking over of assets owned by foreign owners. This led to foreign investors suffering significant losses. In order to curb the situation, the developed nations got involved in negotiating bilateral investment treaties (BITs)[[5]](#footnote-6). This provided protection to the investors and simultaneously encouraged the developing nations to welcome foreign investment. The first BIT was signed between Germany as a developed nation and Pakistan as the developing Nation in 1959. However, the lack of an effective mechanism to practically apply protective guidelines led to the formation of ISDS. The first case of ISDS was brought under the International Centre of Settlement of Investment Disputes (ICSID) in the year 1972[[6]](#footnote-7). The ICSID was established by the Convention on the Settlement of Investment between States and Nationals of other States.

However, over the years the ISDS system has experienced significant expansion as well as changes in its original regime. Also, the system has experienced significant criticism from the masses in terms of its transparency and limited availability of investors to actually make use of the ISDS system in order to challenge measures of legitimate public policies. According to the United Nation Conference on Trade and Development (UNCTAD) Also there were few cases of ISDS before 2000, There has been a significant rise in the number of cases by the end of 2020. One of the major drivers of such growth in the number of cases has been due to the number of cases related to International Investment Agreements (IIAs). The agreement contains ISDS provisions which are well-equipped provisions to provide protection to the foreign investors. It also shows the investors that their investment would be safe from misuse or misplacement. Another factor that has led to the increasing number of cases is the expansion of the system beyond the boundaries of developed nations. Developing nations are increasingly signing the IIAs provisions which have led to the diversification of the range of cases and disputes resolved by the system. These also include investors in emerging markets as well as the host states. At the end of 2021, approximately 1200 cases of ISDS were registered[[7]](#footnote-8). This is a contribution of the awareness as well as acceptance of the ISDS provisions on a wider range of investor population as well as the understanding associated with the protection asserted by the system to the investors.

Countries across the world have signed IIAs among themselves in order to promote cross-border investments and trade activities[[8]](#footnote-9). It also promotes economic cooperation between countries as well. In addition to this, with the increasing globalisation in the international market, the increase in the flow of FDI has risen. As a result of this, the potential and probability of the countries getting engaged in disputes have also increased. This further leads to an increase in the number of cases related to ISDS systems in front of the tribunals.

The lack of *transparency of the ISDS system and accountability* to the results erodes the rule of law as well as the principles associated with the democratic governance. This questions the legitimacy of the system as well as the impact of the challenges upon the sovereignty of the states and its public policy. The limitation of the system associated with the transparency occurs due to the fact that the proceedings are not conducted in front of the public but behind closed doors. This limits the scrutiny process by the public. As a result of this, the outcomes of the proceedings most often than not are perceived as discriminatory and unjust. The tribunal of the ISDS system also lacks in taking into account the ability of the outcomes. That is the tribunals are not subjected to judicial or democratic oversight. The decisions made by the tribunals of the system can not be appealed, thus leading to misuse of power and engagement with abuse and bias in the decision making process[[9]](#footnote-10).

The system also has a huge potential to *undermine domestic policy-making* in a number of ways. One of the main issues associated with the ISDS is the fact that the policy proceedings discourage the government to regulate it in the interest of the public especially in areas including the protection of the environment, labour rights as well as health of the public[[10]](#footnote-11). This is particularly because of the fact that the investors can make use of the ISDS system to challenge the regulations. They can argue that the regulations are infringing the rights of Investments in terms of the investors even if it is a matter of public welfare. As a result of this, governments of the states are reluctant to adopt new policies and regulations that may avoid the risk associated with the ISDS claims. Another challenge of the ISDS system is the fact that it may lead to “chilling effect” on the policy making[[11]](#footnote-12). That system has the ability to limit the response of the government in terms of emerging social, environmental and economic challenges of the states which undermine and restrain the government from engaging in democratic procedures.

The system also has a huge impact on the *sovereignty of the host state*. Sovereignty is basically the power of governing itself and the ability to make regulations in the public interest without the involvement of external bodies or the fear of being questioned by foreign investors. However, the system allows investors from foreign lands to file a case against the host state as well as ask for compensation in case they believe that their investments are being misused by the state. It also allows the investors to take legal action against the state in case they develop a policy or pass a law that affects the profits and investments of the foreign investors. In addition to that, the *costs associated with the ISDS cases are extremely high* for the stakeholders[[12]](#footnote-13). In case of developing countries or organisations that are small or medium size, can experience extreme difficulty in pursuing the legal proceedings associated with the system. The legal cost, that is the fees charged by the lawyers are high as well as there are additional expenses in proceeding the case which include travel expenses, the cost of witnesses and others. As a result of this, the system has received criticism in terms of its affordability for developing nations and smaller states. With the strict finances and limited financial resources of the smaller States, affording a good lawyer and pursuing the proceeding is not very advantageous or feasible. Additionally, the smaller state may not even have the accessibility to the same level of legal expertise as the larger states or multinational organisations.

The arbitrators play an integral part in the legitimacy of the ISDA system, the arbitrators are nominated by the host country, ISDS and the foreign country. However, the arbitral institute can allow parties to change the arbitrators and replace them with another arbitrator. There is a continuous debate on the changing natures of arbitrators. The arbitral institution recently developed new approaches to remove the inconsistency in the arbitral system, the new approaches are directed towards removing the challenges and conflicts that arise in the arbitral system. The affords have been directed towards developing a uniform system of arbitral institutions and the focus has been shifted from individual arbitrary institutions. The new reforms processes of the ISDS system, have been implemented to ensure that the arbitrators remain impartial throughout the procedure. Special importance has been given on the fact that all the arbitrators need to commit to ensuring that they will not lose their integrity during the procedures and that their decisions making processes will be impartial and based on true facts. This further implies that the authenticity and credibility of the results of the conflicts and disputes will be acceptable to both the host state and the foreign state.

There are various forms ethical issues in the ISDS system, primarily on the part of the arbitrators. Partiality, personal biases are common in the arbitrators, and consequently the results of the procedures are biased. Moreover, it has been found that the confidentiality of information is not well maintained in the ISDS system. To overcome ethical issues, an arbitrator has to comply with ADR rules and regulations regarding confidentiality. The reasonable expectations of both the host state and the foreign state need to be considered by ISDS, however, the decisions taken by the Arbitrators have to be bias-free in order to maintain transparency. By abiding by the rules of ADR, arbitrators can further earn the trust and consequently, the ISDS system will be trusted at the same time. Decisions should be free of cultural, national, ethnical or any other form of biases.

The ISDS system has been facing a serious legitimacy challenge, which is responsible for the upsurge in the very foundation of the system. According to scholars, this crisis can be divided into two sects, one is a procedural crisis and the other one is a substantive crisis. A procedural crisis has been referred to as one, which might be addressed by reform, whereas a substantive crisis has been identified as one that can threaten the existence of the entire regime.

The procedural legitimacy crisis is an internal matter of the system and it has emerged from the issues created by the ways in which ISDS is dispensed. These issues are addressed by reform and the entire system does not require overhauling[[13]](#footnote-14). UNCITRAL has recognised earlier and asserted the need for the reformation of the ISDS system. UNCITRAL has proposed three major reforms, which can be adopted in the system. The very first proposal indicates that a “stand-alone review or appellate mechanism” can be introduced. The second proposal hinted that a “multilateral investment court” can be created. The third proposal articulated that the “selection and appointment of arbitrators and adjudicators” should be done in a fairer manner. The purpose of these proposals was to recognise the internal legitimacy problems of ISDS and therefore these proposals aimed to reform this system internally. However, the UNCITRAL did not seek to overhaul the entire system, rather it sought to reform some of the procedures of the ISDS system.

Therefore in order to resolve the challenges associated with the ISDS system, several reforms have been proposed. One such reform includes the proposal to increase the transparency of the ISDS proceeding[[14]](#footnote-15). Proposals have been made to conduct the hearing by tribunes in front of the public. It has also been proposed that the decisions for a particular case must not be taken behind closed doors. This will open up the decision making process and at the same time reduce the chances of making biased decisions by those tribunals in terms of the investors. In case the proposal gets passed, The tribunals responsible for hearing the cases between investors and states, conducting the proceedings of the dispute resolution process as well as reaching a final decision against the case will have to maintain complete transparency and will not be able to engage with any discriminatory practices or biases. Therefore, giving a chance to both parties to have justice equally. It will also lead to the tribunal taking accountability of the decisions leaving less scope of being criticised.

Another reform associated with the ISDS system that has been proposed is the selection of arbitrators who are free of biases[[15]](#footnote-16). That is the potential of the lawyers and the arbitrators to make biased decisions can be revoked by involving arbitrators belonging to diverse cultural groups. This will enhance the chances of the decision making process being acceptable and legitimate in the public eyes. An arbitrator belonging to a different gender, religion or cultural background addressing the proceedings of a case have more chances of making unbiased decisions and less chances of favouring the investors. This will ensure that the proceedings are conducted in a proper manner without engaging in unfair practices. This particular proposal will also ensure that the ethical standards for arbitrators are maintained as well[[16]](#footnote-17).

Interference of investors in the decision making processes being another issue of the ISDS cases, reforms have been suggested by authorities and states to increase the concreteness of the ISDS structure and decision making body in order to completely avoid the chances of investors interfering decisions and influencing the decision makers to engage with answer practices of decision making. In addition to that, due to the broad scope of the ISDS treaties, it has been proposed that exceptions need to be made in the system and its framework so that governments of state and developing nations are capable of designing policy without living in the fair of getting sued. The exceptions may include public safety in terms of their health, environmental protection as well as human rights. This will enable the regulation and policies developed by the state to be free from being influenced by the investors in any way. Proposals also have been made in terms of establishing permanent quotes for investment issues in order to resolve the problem associated with making appeals in case the state feels that the decisions made by the judge are unfair. This will broaden The aspect of justice in terms of the states and the public due to the fact that the courts are staffed by judges instead of arbitrators. This will ensure that the system becomes more transparent and accountable as well.

In the case of Phillip Morris v. Uruguay, which is the high profile ISDS case, originated in the year 2010. The case was filed against the government by the Phillip Morris company which is one of the largest manufacturers in the world. The Uruguay government passed a law stating that the cigarette manufacturing companies will have to display the health hazards related to the product on the packaging itself. This was the measure taken by the government in order to create public awareness as well as reduce smoking in order to improve the overall public health of the nation. In return, the company argued that the government has violated the intellectual property rights of the company as well as infringed their trademark and brand image in the market[[17]](#footnote-18). However, the ISDS tribunal ruled in favour of the government and rejected the plea of the company. The tribunal cited that similar burning has been effective in reducing smoking in other countries.

In another case between Lone Pine v. Canada, which arose in 2013 is also a case of ISDS. In this case, Lone Pine resources which is an energy company based in Quebec filed a case against the Canadian government Under the North American free trade agreement (NAFTA) saying that the moratorium constituted a violation of its property rights[[18]](#footnote-19). As a result of this, the company even suffered damages as well. The case raised several issues related to the invested protection under the ISDS system as well as highlighted the imbalance of power between the investor and states. However, the tribunal ruled on the Canadian government and dismissed the claims made by the company on the basis of jurisdictional grounds. The Tribunal also rejected the compensation of $250 million By the Lone Pine resources against the damages incurred due to the moratorium. Later, the critics of the ISDS system who previously argued that the Tribunal willingly favoured the investors, signal to the Tribunal conducted greater scrutiny against the claims made by Lone Pine instead of simply favouring the investment company.

The Chevron v Ecuador case is one of the most famous ISDS cases[[19]](#footnote-20). The case initially originated in 1993 which lasted till 2011. Initially Texaco began the exploration of oil and conducted production activities in the Ecuadorian region of Amazon. The company was later acquired by Chevron. Hence the case got its name from there. The oil exploration activities of the company resulted in significant damages to the environment which also contaminated the water resources and the soil in the region. The Ecuadorian plaintiff filed the case against Chevron in the federal court of the US, seeking compensation for the environmental damages of the region as well as the health issues caused by the company to the public in that area. In return, The company told you that the case should be heard in Ecuador itself citing that the action has taken place in the Ecuadorian region as well as stating that Texaco paid for the cleaner under the agreement for settlement with the concerned government of the states. However, in 2011, the court ruled in favour of the Ecuadorian Government and ordered the company to pay for the damages. The company refused to pay for the damages and filed a claim under the ISDS system. The tribunal ruled in favour of Chevron and ordered the Ecuadorian government to pay $112 million in compensation to the company stating that the government had violated the obligations provided to the company.

# III. Conclusion

To conclude this study, it can be noted here that ISDS is a legal mechanism that protects the investment of foreign investors. Historically, the first BIT was signed in 1959 between two countries namely Germany and Pakistan, where Germany was a developed country and Pakistan was a developing country. The first case of a dispute was brought in ICSID in 1972. The purpose of the establishment of ICSID was to settle disputes on foreign investments.UNCTAD has found that before 2000, the cases that were raised at ICSID were low in number, however, after 2020, the number of cases are increasing drastically. The upsurge in such cases is also the result of International Investment Agreements (IIAS). Counties are signing IIAS in order to increase cross-border investments and promote economic cooperation all over the world. Moreover, due to globalisation, the inflow of FDI has increased significantly in recent years and thus more cases are coming to ISDS.

However, there are significant legitimacy challenges and transparency in the ISDS system, and due to this, the accountability of the results is at times against the principles of a democratic government. Therefore, it is important for the system to go through some reformations. The very first reformation is that the transparency of ICDS proceedings needs to be enhanced. The second most crucial reform is that the arbitrators need to be selected after ensuring that they are bias-free. The decision-making processes of ISDS have to be free and authentic so that the credibility of the system remains intact.

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