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EU PROPOSALS TO REFORM THE INVESTOR-TO-STATE DISPUTE SETTLEMENT SYSTEM – A CRITICAL ANALYSIS OF SELECTED ISSUES ADDRESSED IN THE CONCEPT PAPER "INVESTMENT IN TTIP AND BEYOND – THE PATH FOR REFORM"

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I. INTRODUCTION

Presently we may observe a growing number of claims filed by foreign investors challenging a wide range of government measures, including laws, regulations, and administrative decisions in all sectors of the economy on the basis of bilateral or multilateral investment treaties.[1] However, many states, academics and non-governmental organizations are fuelling a backlash against the current form of the investor-to-State dispute settlement ("ISDS") system.[2] Among the issues causing controversy are: lack of transparency of the arbitration process, questions surrounding the impartiality and independence of arbitrators, predictability and consistency of treaty interpretation, and the high costs involved. Many commentators question even the legitimacy of investment arbitration as a chosen method of dispute settlement.[3]

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[1] UNCTAD, World Investment Report 2015, Reforming International Investment Governance, 114, http://unctad.org/en/PublicationsLibrary/wir2015_en.pdf, accessed on 5 October 2015 ("UNCTAD 2015 Report").
[2] Michael Waibel, Asha Kaushal, et al. (eds), *The Backlash against Investment Arbitration* (Kluwer Law International 2010).
[3] Susan D. Frank, 'The Legitimacy Crisis in Investment Treaty Arbitration: Privatizing Public International Law Through Inconsistent Decisions' (2005) 73 (4) Fordham Law Review.

These concerns are the subject of a vital discussion in the context of the European Union, which is currently involved in negotiations with the United States regarding the Transatlantic Trade and Investment Partnership[4] ("TTIP"), which also includes ISDS mechanisms. In these circumstances, the European Commission, which has a mandate to negotiate TTIP, released a concept paper in May 2015 titled "Investment in TTIP and beyond – the path for reform" ("Concept Paper")[5] presenting its position on the shape of the ISDS system in TTIP as well as more general conclusions concerning reform of investment arbitration in the EU.[6]

The Concept Paper is based on the results of public consultations[7] on investment protection and ISDS in TTIP, which were organized in order to gather views from the public on how the EU could further develop its approach. These consultations have shown that there is considerable scepticism as to ISDS instruments, and four areas were identified where particular concerns were raised and further improvements to the EU's approach should be explored: i) the protection of the right to regulate; ii) the establishment and functioning of arbitral tribunals; iii) the review of ISDS decisions through an appellate mechanism; iv) the relationship between domestic judicial systems and ISDS.[8] The results of the public consultations were presented in a report titled "Online public consultation on investment protection and investor-to-state dispute settlement (ISDS) in the Transatlantic Trade and Investment Partnership Agreement" ("Report on Public Consultations").

The Concept Paper consists of two fundamental parts. The first one describes the developments regarding ISDS resulting from two treaties - the Comprehensive Economic and Trade Agreement between the EU and Canada[9] ("CETA"), and the Free Trade Agreement between the EU and Singapore[10] ("EU-Singapore FTA"), in whose case negotiations have already concluded. The second part of the Concept Paper focuses on further improvements to ISDS that are to be employed in TTIP and may be treated

[4] http://ec.europa.eu/trade/policy/in-focus/ttip/about-ttip/, accessed on 5 October 2015.

[5] 'Investment in TTIP and beyond – the path for reform', http://trade.ec.europa.eu/doclib/docs/2015/may/tradoc_153408.PDF, accessed on 5 October 2015.

[6] Since negotiations between the EU and the US are not yet completed, the purpose of this paper is to analyze main EU proposals regarding reform of the ISDS system as reflected in the Concept Paper rather than the wording of any provision proposed by one of the parties. However, the authors note that the EU has made public its textual proposals for Investment Protection and Resolution of Investment Disputes chapter of TTIP. The EU textual proposal titled 'Transatlantic Trade and Investment Partnership, Trade in Services Investment and E-commerce, chapter II - Investment' is available on http://trade.ec.europa.eu/doclib/docs/2015/november/tradoc_153955.pdf, accessed on 9 August 2016.

[7] Report 'Online public consultation on investment protection and investor-to-state dispute settlement (ISDS) in the Transatlantic Trade and Investment Partnership Agreement', http://trade.ec.europa.eu/doclib/docs/2015/january/tradoc_153044.pdf, accessed on 5 October 2015 ("Report on Public Consultations").

[8] Report on Public Consultations 4.

[9] http://ec.europa.eu/trade/policy/countries-and-regions/countries/canada/, accessed on 5 October 2015.

[10] http://ec.europa.eu/trade/policy/countries-and-regions/countries/singapore/, accessed on 5 October 2015.

as a basis for reform of ISDS involving the EU. The European Commission believes that the proposals made in the TTIP context will set the standard for further development of investment protection provisions.[11] The Concept Paper was intended to serve as a basis for discussion with the European Parliament and the Council regarding the future of TTIP and the ISDS system in the EU. The Commission's proposals are now at the heart of the debate about investment arbitration reform.

Taking into consideration the above, the subject of the analysis presented in this paper are the Commission's proposals regarding the ISDS reform included in the Concept Paper. The authors' aim is to pursue a critical analysis of the proposals and to determine to what extent they satisfy the expectations expressed by ISDS participants. The authors will also consider whether the Commission's proposals could help solve the problems currently facing international investment law and investment arbitration.

The hypothesis of this article is that the Concept Paper includes ideas which have been welcomed by the arbitration community, and which may result in greater transparency and predictability of the ISDS system; however, it also contains proposals that are controversial and which will possibly weaken the investment protection provided by international law. The conclusions as to which ideas are potentially beneficial for ISDS and which would need further elaboration will be presented in the final thesis.

In the following parts of this article the authors will examine crucial issues raised in the Concept Paper. For the sake of transparency, the paper starts with ideas which have been found to be potentially advantageous for ISDS and then moves on to those raising certain concerns.

II. INTRODUCTION OF AN APPELLATE MECHANISM

As a rule, ISDS lacks an appellate mechanism within the meaning of this term in domestic law. This can be perceived as both an advantage or as a drawback of this manner of dispute resolution. On the one hand, the absence of an appeal stage helps to conclude arbitration proceedings within a relatively shorter period of time than in domestic courts. The introduction of an appellate mechanism would add another layer of proceedings to the process, which could potentially endanger its efficiency. Furthermore, proceedings at the appellate stage would also burden the parties with additional costs.[12] As the Report on Public Consultations reveals, in the opinion of some business associations an appellate mechanism "risks compromising the finality of arbitration", thus undermining its fundamental basis.[13]

On the other hand, an appellate mechanism would enable verification of arbitral tribunals' decisions also on grounds not enumerated in the New York Convention on the Recognition and Enforcement of Foreign Arbitral

[11] Concept Paper 4.
[12] UNCTAD 2015 Report 150.
[13] Report on Public Consultations 24.

Awards of 1958.[14] Supporters of introducing an appellate mechanism into ISDS argue that the appellate system would enhance the legitimacy of investment arbitration and reinforce fairness and balance among the various players in investment disputes.[15] It is also believed that the appellate mechanism could significantly contribute to the political acceptability of the ISDS regime.[16]

In its Concept Paper the European Commission proposes adding an appellate mechanism to ISDS.[17] The Commission suggests that it is "one of the most persistent criticisms of the international investment arbitration process (…) that ISDS tribunals can get their decisions wrong, and there is no corrective mechanism via an appeal, as is found in almost all legal systems."[18] It is also reported that the proposal to introduce the appellate mechanism has gained the broadest support during consultations conducted among business representatives and various NGOs,[19] although in the Report on Public Consultations the Commission indicated that "the proposal for an appeal mechanism is neither fully opposed nor fully supported."[20] If there is a need among investors, who are the main beneficiaries of ISDS, to introduce an appellate mechanism into investment arbitration, then the proposal of the Commission should be assessed positively.

In principle, the Commission proposes following the example of the WTO appellate mechanism. The WTO set out its dispute settlement system in the Understanding on Rules and Procedures Governing the Settlement of Disputes ("Understanding Agreement").[21] The WTO dispute settlement system, including its appellate mechanism, has strong supporters, who emphasize *inter alia* that appeals to the WTO appellate body are "decided by a committee that benefits from the collective expertise, diversity and sustained working relationship of its members, which has been viewed as the touchstone of consistency and the reduction in the unpredictability of the WTO decisions."[22]

However, the Commission's proposal also raises some concerns, especially with respect to the suggested grounds for appeal. The Commission is of the view that arbitral awards should be reviewed on grounds of errors of law and manifest errors in the assessment of facts.[23] However, Article 17 (6) of the Understanding Agreement, which is supposed to serve as a model, stipulates that an appeal "shall be limited to issues of law (emphasis added) covered in the panel report and legal interpretations (emphasis added)

[14] 330 UNTS 3.
[15] Yengkong Ngangjoh-Hodu, Collins C. Ajibo, 'ICSID Annulment Procedure and the WTO Appellate System: The Case for an Appellate System for Investment Arbitration' (2015) 6 Journal of International Dispute Settlement 308.
[16] UNCTAD 2015 Report 150.
[17] Concept Paper 8.
[18] ibid.
[19] ibid.
[20] Report on Public Consultations 24.
[21] *Marrakesh Agreement Establishing the World Trade Organization*, Annex 2, the legal texts: the results of the Uruguay round of multilateral trade negotiations 354 (1999) 1869 UNTS 401, 33 ILM 1226.
[22] Ngangjoh-Hodu, Ajibo (n 15) 321.
[23] Concept Paper 9.

developed by the panel." It is therefore necessary to consider whether the grounds proposed by the Commission for appeal are not too broad.

In the authors' opinion, the grounds for appeal could be limited to significant or manifest errors of law. Overly broad grounds for appeal would create a risk of protracted proceedings. Investment arbitration disputes are typically complicated and involve significant financial resources expended by the parties. The risk that entire proceedings could be repeated due to alleged errors of law not of a manifest nature would be detrimental to ISDS.

The authors also believe that manifest errors in the assessment of facts should not serve as grounds for appeal, as the assessment of facts is always subjective and thus should be left to the discretionary competence of arbitrators. It is noted that generally "the existing international appellate mechanisms address only the erroneous application of the law to the facts. They do not address differences in the appreciation of the facts by the tribunal of first instance."[24]

During public consultations pertaining to the grounds for appeal, most of the respondents commenting on this issue considered that it should not admit a full review (law and facts), but only a review of legal grounds. This view was expressed by a number of NGOs as well as by some business associations and companies.[25]

While creating the final catalogue of grounds for appeal, both the regulation of the Understanding Agreement (Article 17) and Article 52 of the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States of 1965 should be taken into account, with the stipulations made above.

The absence of an appellate mechanism in ISDS constituted a fundamental feature of this dispute resolution method. The need for its introduction may be real; however, at the same time, the proposed solutions should consider the arguments of opponents of a revolution in this respect. In the authors' view, the proposal to introduce an appellate mechanism could be beneficial for the system, but it requires reconsideration in respect to the grounds for appeal. A proper mechanism should weigh the rights and interests of both the winner and the loser of a dispute.

III. ADMISSIBILITY OF *AMICUS CURIAE* BRIEFS

The essence of ISDS lies in verifying whether certain government measures taken towards foreign investors are in conformity with international investment law, particularly with any investment treaty concluded between the host state and an investor's home state. While investment disputes usually concern politically and socially sensitive issues, such as exploration of natural

[24] Barton Legum, 'Appellate Mechanism for Investment Arbitration: Worth a Second Look for the Trans-Pacific Partnership and the Proposed EU-US FTA?' (2014) 11 (1) Transnational Dispute Management 3.
[25] Report on Public Consultations 25.

resources,[26] building of water systems[27] or production of energy,[28] awards in favor of investors may threaten public interests, for example, by increasing the cost of public welfare regulation or the operation of public services.[29] Moreover, as the amounts in damages that are sought by investors are usually very high, public opinion in responding states is interested in the conduct and results of arbitration proceedings which significantly impact states' budgets. This is why, for around a decade,[30] there have been widespread proposals to incorporate a social element into ISDS by enabling third parties, who most often are NGOs, to provide the arbitral tribunal with a written statement on the issues in dispute (*amicus curiae* briefs).

The Concept Paper postulates that TTIP should provide for a possibility that the arbitration tribunal may accept *amicus curiae* briefs from third parties under certain conditions, in line with the recently-agreed UNCITRAL Rules on Transparency[31] - similar to present CETA and EU-Singapore FTA provisions. Moreover, the Concept Paper emphasizes the need for third parties' right to intervene if they have a direct and existing interest in the outcome of a dispute, in addition to the idea of the *amicus curiae briefs*.[32]

In general, the decision to admit *amicus curiae* briefs falls within the scope of the arbitral tribunal's discretionary competence to conduct the proceedings in a manner the tribunal finds appropriate. However, such a decision may depend on the consent of the parties to the dispute.[33] Additionally, since 2006, Article 37(2) of ICSID Arbitration Rules[34] expressly allows the tribunal, after having consulted the parties, to admit an *amicus curiae brief* from a non-disputing party under the condition that *inter alia* such a submission would assist the tribunal in the determination of a factual or legal issue related to the proceedings by bringing in a perspective, particular knowledge or insight that is different from that of the disputing parties, and the non-disputing party has a significant interest in the proceedings. A similar solution is employed in Article 8 of the UNCITRAL

[26] *Liman Caspian Oil BV and NCL Dutch Investment BV v. United Republic of Tanzania,* [2010] ICSID Case No. ARB/07/14.
[27] *Bitwater Gauff Ltd. (Tanzania) v. United Republic of Tanzania,* [2006] ICSID Case No. ARB/05/22.
[28] *Vattenfall AB, Vattenfall Europe AG, Vattenfall Europe Generation AG v. Federal Republic of Germany,* [2011] ICSID Case No. ARB/09/6.
[29] Amokura Kawharu, 'Participation of Non-governmental Organizations in Investment Arbitration as Amici Curiae' in Michael Waibel, Asha Kaushal, et al. (eds), *The Backlash against Investment Arbitration* (Kluwer Law International 2010) 283.
[30] In *Methanex v. United States of America,* the tribunal determined that the undoubted public interest in the arbitration, arising from its subject matter, was a factor in favor of the tribunal exercising its discretion to allow the petitioning NGOs to participate as *amici*, Letter from Tribunal (on amicus), http://www.italaw.com/sites/default/files/case-documents/ita0524.pdf, accessed on 9 August 2016.
[31] http://www.uncitral.org/pdf/english/texts/arbitration/rules-on-transparency/Rules-on-Transparency-E.pdf, accessed on 5 October 2015.
[32] Concept Paper 8.
[33] Letter of the chairman of the Tribunal dated 29 January 2003 in case *Aguas del Tunari S.A. v. Republic of Bolivia* ICSID Case No. ARB/02/3.
[34] https://icsid.worldbank.org/ICSID/StaticFiles/basicdoc/partF-chap04.htm#r37, accessed on 5 October 2015.

Rules on Transparency[35] which further emphasizes that "the arbitral tribunal shall ensure that the disputing parties are given a reasonable opportunity to present their observations on any submission by the third person."

Taking into account that a third party's submission becomes a standard in investment arbitration, the proposal of the Commission is not controversial. However, it should be noted that *amicus curiae* briefs are a less meaningful tool if they do not have full access to the files of the case and cannot attend hearings. Third-party briefs without additional guarantees of transparency will be ineffective. Therefore, the EU should adopt a full package of tools ensuring transparency of ISDS. The easiest way to do so is by incorporating the UNCITRAL Rules on Transparency into the treaty, as has already been done in CETA[36] and EU-Singapore FTA.

Interestingly, the Commission's proposal differentiates between the third parties' right to submit *amicus curiae* briefs and the right to intervene in proceedings. However, this distinction is unclear as usually third parties' right of intervention in investment arbitration is exercised by means of written submissions serving as an aid to the tribunal.[37] Therefore, it is unclear what the procedural framework would be for such an intervention.

IV. MEASURES AGAINST PARALLEL PROCEEDINGS

The Commission, following scholars and practitioners,[38] addresses the problem of parallel proceedings pursued before state courts and arbitral tribunals which pose serious risks of inconsistent decisions and double recovery. A good example of the latter problem is *Bosca v. Lithuania*[39], in which the tribunal found there had been a breach of the BIT, but refused to award compensation as the investor had already been reimbursed by the respondent on the basis of a decision by the Supreme Court of Lithuania. However, there is no established principle according to which if compensation is granted to a claimant at the domestic level, it would affect a shareholder's claim under the BIT, and vice-versa.[40]

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[35] https://www.uncitral.org/pdf/english/texts/arbitration/rules-on-transparency/Rules-on-Transparency-E.pdf, accessed on 5 October 2015.

[36] http://trade.ec.europa.eu/doclib/docs/2013/november/tradoc_151918.pdf, accessed on 5 October 2015.

[37] Eugenia Levine, 'Amicus Curiae in International Investment Arbitration: The Implications of an Increase in Third-Party Participation' (2011) 29 (1) Berkley Journal of International Law Volume 207.

[38] August Reinisch, 'The issues raised by parallel proceedings and possible solutions' in Michael Waibel, Asha Kaushal, et al. (eds), *The Backlash against Investment Arbitration* (Kluwer Law International 2010) 112 ff.

[39] *Luigiterzo Bosca v. Lithuania,* [2013], http://www.italaw.com/cases/2076, accessed on 9 August 2016.

[40] David Gaukrodger, 'Investment Treaties and Shareholder Claims: Analysis of Treaty Practice' OECD Working Papers on International Investment 2014/03, http://dx.doi.org/10.1787/5jxvk6shpvs4-en, accessed on 9 August 2016.

According to the Concept Paper, the EU will use instruments – 'fork in the road' or 'no U turn' – which have previously been used in the practice of performing investment treaties. However, it is important to note the potential weaknesses of such solutions and to eliminate them in the course of negotiations of a particular treaty.

A 'fork in the road' clause requires an investor to decide at the very beginning whether the dispute will be adjudicated in state courts or through international arbitration. The investor has no recourse to the other forum after it has made a selection.[41] On the other hand, a 'no U turn' clause permits an investor to make a final decision on the venue at a later stage, e.g. after starting the proceedings in the host state's courts. Once an investor has opted for international arbitration, it cannot revert back to domestic courts.[42] The above clearly shows that 'fork in the road' clauses may discourage recourse to local courts, while 'no U turn' provisions do not have such an effect. Indeed, if an investor wishes to preserve its right to resort to international arbitration, it is likely to avoid domestic litigation. This, in turn, is not in the interest of host states since governments normally prefer to settle the dispute before their own courts.

While assessing the Commission's proposal for measures eliminating parallel proceedings, one must bear in mind that the effectiveness of both 'fork in the road' and 'no U turn' clauses mostly depends on who the addressee of such provisions is, and how their subject matter is defined. Domestic proceedings often involve a claim submitted by an investor's local subsidiary, rather than the investor itself, thereby defeating the identity-of-the-parties requirement which is identical in both clauses. Furthermore, the legal grounds on which a domestic claim is made involve a breach of contract concluded with a state entity or a violation of national law. It is uncommon to base such a claim on a violation of international investment law principles. Following the above, the provisions of BIT aimed at elimination of parallel proceedings may become useless.

However, such problems can be solved by the way in which 'fork in the road' and 'no U turn' clauses are drafted. Namely, they should exclude the possibility of taking a dispute having the same subject matter or referring to the same regulatory measure of a host state before another forum.[43]

[41] UNCTAD, 'World Investment Report 2014, Investor-state dispute settlement. UNCTAD Series on Issues in International Investment Agreements' 87, http://unctad.org/en/PublicationsLibrary/diaeia2013d2_en.pdf, accessed on 5 October 2015 ("UNCTAD 2014 Report").

[42] UNCTAD 2014 Report 86-87.

[43] Article 28(3) of the investment agreement *Common Market for Eastern and Southern Africa (COMESA)* of 2007 stipulates that "If the COMESA investor elects to submit a claim at one of the forums set out in paragraph 1 of this Article, that election shall be definitive and the investor may not thereafter submit a claim relating to the same subject matter or underlying measure to other forums."

V. ENHANCEMENT OF STATES' RIGHT TO REGULATE

One of the core issues raised in the Commission's Concept Paper is an enhancement of states' right to regulate.

The right to regulate in international investment law is a legal right that permits departure from specific investment commitments assumed by a state, without incurring a duty to compensate.[44]

The Commission presents in this respect not only its own view. The need for protection and enhancement of the right to regulate was also stressed by the EU Parliament in its resolution of 6 April 2011 on the future of European international investment policy.[45] The EU Parliament indicated that future investment agreements concluded by the EU must respect the capacity for public intervention and expressed its deep concern "regarding the level of discretion of international arbitrators to make a broad interpretation of investor protection clauses, thereby leading to the ruling out of legitimate public regulations."[46] The EU Parliament called on the Commission to include in all future investment agreements specific clauses laying down the right of states to regulate, *inter alia*, in the areas of protection of national security, the environment, public health, employees' and consumers' rights, industrial policy and cultural diversity.[47]

Further to this statement, the Commission decided to enhance governments' ability to regulate by including an operational provision in the negotiated investment agreements. According to the Commission, states should have a right to take measures to achieve legitimate public policy objectives on the basis of the level of protection that they deem appropriate.[48] The proposal of the Commission aims to address the concerns that ISDS offers investors the right to sue governments whenever new legislation adversely affects their profits.[49]

The right to regulate has been recognized *inter alia* in CETA, which is referred to in the Concept Paper as an example of a regulation addressing this issue.[50] The text of the agreement is not yet binding, and will only become so after completion of the ratification process.[51] Nevertheless, it constitutes a relevant point of reference when considering the Commission's proposals, as the final wording of TTIP provisions will probably be similar that of CETA provisions.

The aforementioned proposal to include in TTIP a provision safeguarding the state's right to regulate raises various questions.

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[44] Catharine Titi, *The right to regulate in international investment law* (Baden-Baden 2014) 52.
[45] No. P7_TA(2011)0141, (2010/2203(INI)).
[46] ibid.
[47] ibid.
[48] Concept Paper 6.
[49] ibid 5.
[50] Concept Paper 5, 6.
[51] http://ec.europa.eu/trade/policy/in-focus/ceta/, accessed on 8 October 2015.

First of all, it is not known what legal effects the inclusion of the right to regulate as an operative clause in TTIP would have. The question of the relation between a state's right to regulate and investors' right to just, prompt and adequate compensation for a breach of the BIT constitutes the subject of an ongoing debate, both among scholars and arbitrators handling investment disputes.[52] To date, the question about the line between non-compensatory regulatory activity of a state and activity falling in the category of compensable violations of BITs has not been answered, even though an increasing number of arbitral cases and a growing body of literature have shed some light on the issue.[53]

Secondly, the Concept Paper does not specify whether an assessment in respect of the rightness and proportionality of a state's adopted measure would fall under the remit of the state itself, and would thus constitute an unverifiable decision of the engaged regulating power, or would fall within the scope of the power of arbitrators. The first solution might be suggested by the wording used in the Concept Paper, according to which states are allowed to "take measures to achieve legitimate public policy objectives, on the basis of the level of protection that they deem appropriate (emphasis added)."[54]

Considering the relation between non-compensatory regulatory measures and compensable violations of BITs, it should firstly be mentioned that a state's right to regulate forms a part of customary international law.[55] The capacity of a state to regulate is embedded in customary international law as a basic attribute of sovereignty and sovereign equality.[56]

It means that within its jurisdiction, a state may adopt such measures as it perceives necessary and justified. This entitlement is not, however, absolute. Limits on the right to regulate come *inter alia* from other sources of international law, such as international treaties, including BITs.

As a consequence of the conclusion of various BITs, states have undertaken obligations to mutually protect and promote investments. More specifically, states have undertaken e.g. to protect investments from expropriation or provide investors with fair and equitable treatment.[57]

As mentioned above, one of the core problems in international investment law is the delimitation between exercising the right to regulate that does not result in a duty to compensate, and an activity by a state which violates investors' rights and thus requires payment of adequate compensation.[58]

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[52] See e.g. Titi (n 44).

[53] Katia Yannaca-Small, 'Indirect Expropriation and the Right to Regulate: How to Draw the Line? in Katia Yannaca-Small (ed) *Arbitration under International Investment Agreements; A Guide to the Key Issues* (Oxford 2010) 446.

[54] Concept Paper 6.

[55] *Feldman v. Mexico,* [2002] ICSID Case No. ARB(AF)/99/1 para 103; Caroline Henckels, 'Indirect expropriation and the right to regulate: revisiting proportionality analysis and the standard of review in investor-state arbitration' (2012) 15 (1) Journal of International Economic Law 225.

[56] Titi (n 44) 32.

[57] See e.g. Agreement between the Kingdom of the Netherlands and the Republic of Poland on encouragement and reciprocal protection of investments of 1992, journal no. 1994 no. 57 pos. 235.

[58] See e.g. Henckels (n 55); OECD, '„Indirect expropriation" and the „right to regulate" in international investment law', working paper on international investment, 2004/04.

This issue is of particular importance in respect of indirect expropriation, meaning states' interference with investors' rights causing an effect equivalent to nationalization or expropriation.[59] As a result, the investor is *de facto* deprived of its rights. To date, neither legal scholars nor arbitrators dealing with investment disputes have identified a common solution to the problem.[60]

According to one view, a regulatory measure by a state which significantly interferes with investors' rights does not constitute a compensable expropriation if it was adopted for a public purpose, in compliance with the rules of law and in a non-discriminatory way, unless specific commitments had been given by the regulating government to the foreign investor that the government would refrain from such harmful regulations.[61]

It is also possible to find supporters of the opposite view, according to which a regulatory measure which has caused at least an effect equivalent to expropriation (indirect expropriation) will always give rise to the state's obligation to pay compensation, notwithstanding what objective was underlying the adoption thereof.[62]

In any event, even the supporters of the first view are of the opinion that a state's right to regulate is not absolute, and an adopted measure must fulfil certain prerequisites, i.e. be adopted in good faith and for a public purpose,[63] or be proportional, in order to be qualified as non-compensatory.[64]

The vast majority of participants in the conducted public consultations generally agree with affirmation of the right to regulate in the public interest. However, not as many of them are positive about the proposed approach. For instance, some consider that this approach is insufficient, while others consider it too broad or even contend that there is no conflict between the right to regulate and investment protection.[65]

Within the course of the analysis of the Commission's proposals, it is justified to take into account the relevant provisions of CETA, which state as follows.

Article 8.12 of CETA: "A party shall not nationalize or expropriate a covered investment either directly, or indirectly through measures having an effect equivalent to nationalization or expropriation, except:

(a) for a public purpose;

(b) under due process of law;

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[59] Rudolf Dolzer, Christopher Schreuer, *Principles of International Investment Law* (Oxford 2008) 92.

[60] *Feldman v. Mexico*, [2002] ICSID Case No. ARB(AF)/99/1 para 100.

[61] *Methanex v. USA*, *Final award on the jurisdiction and merits*, NAFTA, part IV, chapter D 4 para 7.

[62] *Compañia del Desarollo de Santa Elena S.A. v. The Republic of Costa Rica*, award, ICSID Case No. ARB/96/1, 2000 para 72; see also considerations presented in *Feldman v. Mexico*, [2002] ICSID Case No. ARB(AF)/99/1 para 98.

[63] Ivar Alvik, *Contracting with Sovereignty* (Oxford, Portland 2011) 263, 265.

[64] *Tecmed v. Mexico*, [2003] ICSID Case No. ARB (AF)/00/2 para 122.

[65] Report on Public Consultations 18.

(c) in a non-discriminatory manner; and
(d) on payment of prompt, adequate and effective compensation."

This means that if the prerequisites listed in Article 8.12 of CETA are met, expropriation (both direct and indirect) is lawful. In case of non-fulfilment of any of the prerequisites, the expropriation is unlawful. Unlawful expropriation means violation of the BIT and thus a breach of international law, creating an obligation to pay compensation; however, this obligation arises not on the basis of the BIT, but on the basis of customary international law,[66] as reflected in the Articles on Responsibility of States for Internationally Wrongful Acts.[67]

According to point 3 of Annex 8-A 'Expropriation' of CETA, which supplements Article 8.12,[68] "except in the rare circumstance where the impact of the measure or series of measures is so severe in light of its purpose that it appears manifestly excessive, non - discriminatory measures of a Party that are designed and applied to protect legitimate public welfare objectives, such as health, safety and the environment, do not constitute indirect expropriations." Recently, the tribunal in the *Philip Morris v. Uruguay* case found that this provision reflects the position under general international law.[69] This means that on the grounds of CETA, adoption of regulatory measures by a state does not constitute indirect expropriation, and thus an investor cannot seek compensation on this basis if:
(a) the measure was adopted for a public purpose (or to be more precise - *legitimate public welfare objective*);
(b) the measure is not discriminatory; and
(d) the impact of the measure does not appear to be manifestly excessive (meaning that the measure must be proportional).

Accordingly, there is a risk that the same measure having an effect equivalent to nationalization or expropriation, adopted for a public purpose, in a non-discriminatory and proportional way (which is a constituent element of the due process rule), may be qualified as an unlawful expropriation if the state did not pay compensation, and at the same time as a non-expropriatory regulatory measure. This may cause serious confusion.

There is no indication that the provisions included in Annex 8-A should be perceived as *lex specialis* with respect to the provisions contained in Article 8.12 of CETA. If the Commission plans to release states from their international obligations to protect investments from indirect expropriations and pay compensation in the event thereof, then it is not known in which situations, if any, compensation will be due on the basis of Article 8.12.

The aforementioned doubts indicate that the proposals in respect to the right to regulate require further consideration. The Commission did not present in the Concept Paper how it plans to resolve this conflict.

These contradictions may have a detrimental effect on the system of investment protection. Participants in the public consultations, mainly from the business community, expressed their opinion that the proposed approach

[66] Dolzer, Schreuer (n 59) 92.
[67] Articles on Responsibility of States for Internationally Wrongful Acts, UN ILC 2001, YILC Vol. II.
[68] See Article 8.12 (1) of CETA.
[69] *Philip Morris v. Uruguay*, [2016] ICSID Case No. ARB/10/7 para 301.

would lower the protection granted to investors because "it allows states not to grant compensation for measures taken in certain sectors (e.g. health). This could prejudice investments in these sectors as compared to investments in other sectors."[70]

It needs to be ensured that the reform will not deprive ISDS of its investment protection function, but will rather achieve a balance between protection of investors and states' need to preserve sufficient regulatory power. How to strike this balance is a strategic choice and a challenge.[71]

Regarding the issue of the assessment of measures adopted by states, it is not specified in the Concept Paper who will be entitled to decide whether a state's measure was legitimate, proportional, non-discriminatory, and adopted for a public purpose. In the Commission's view, governments' entitlement to regulate should be enhanced *inter alia* through the possibility to adopt regulatory measures for public purposes "on the basis of the level of protection that they deem appropriate."[72]

The above leads to the conclusion that such decisions as those regarding the proportionality of a measure rests solely with the state, whereas often that very issue constitutes the main focus of a dispute. If the Commission's aim was to grant states an unlimited margin of appreciation in the assessment of legitimacy and proportionality of a measure, then, in the authors' opinion, such a proposal should be considered unfavourable to mutual promotion and development of investments.

VI. APPLICATION OF DOMESTIC LAW BY ARBITRAL TRIBUNALS AND BINDING EFFECT OF THE INTERPRETATION OF DOMESTIC LAW MADE BY NATIONAL COURTS ON ARBITRAL TRIBUNALS

According to one of the Commission's proposals, arbitrators should be precluded from applying and interpreting domestic law when ruling on investment disputes. The Commission specifically suggests that "in order to ensure certainty with regard to the compatibility of ISDS with the principle of autonomy of the EU legal order (…) it shall be confirmed that:
(a) the application of domestic law does not fall under the competence of ISDS tribunals;
(b) domestic law can be taken into account by ISDS tribunals only as factual matter; and
(c) any interpretations of domestic law made by ISDS tribunals are not binding on domestic courts."[73]

Furthermore, whenever a question of interpretation of domestic law arises, arbitrators will be required to base their decisions on the relevant case

[70] Report on Public Consultations 18.
[71] UNCTAD 2015 Report 131.
[72] Concept Paper 6.
[73] Concept Paper 11.

law of the domestic courts of the respondent state.[74] The wording of the proposal suggests that arbitrators could take national law into account only as a matter of fact and will be bound by interpretations of national law made by domestic courts. These proposals raise serious concerns.

Traditionally, domestic law has been perceived as one of the legal frameworks applicable in international investment disputes.[75] The three main sources of substantive law relevant for the adjudication of ISDS cases include:
(a) the BIT itself;
(b) international law;
(c) domestic law of the host state.[76]

In the authors' opinion, arbitrators should have the possibility to apply and interpret the relevant provisions of domestic law, and the Commission has not presented any convincing arguments to the contrary. The lack of such a possibility would significantly diminish the role of arbitrators. Furthermore, the proposal that arbitrators should be bound by the interpretation of national law made by domestic courts is questionable as interpretation of national law made by domestic courts may not be conclusive, especially when judgments of domestic courts in respect to the same subject matter differ significantly.

VII. INTERNATIONAL COURTS FOR INVESTMENT DISPUTES

The Commission's proposals regarding changes in the process of establishing arbitral tribunals in the ISDS system are probably the most controversial ideas presented in the Concept Paper as "they suggest steps that can be taken to transform the system towards one which functions more like traditional courts systems."[77] Namely, the Concept Paper states that all arbitrators should be chosen from a roster pre-established by the states concluding a relevant BIT, either at random or by the disputing parties. This is justified by the need to "break the link" between the parties to the dispute and the arbitrators. Furthermore, the Commission's idea is to require certain qualifications from the arbitrators, in particular that they are qualified to hold judicial office in their home jurisdiction and have expertise in the field of international law.

The party's right to freely appoint its arbitrator is a key feature of arbitration which makes it distinct from adjudication by permanent - either domestic or international - courts.[78] Results of empirical studies prove that parties' right to select arbitrators is one of the primary reasons they choose arbitration as a means of dispute resolution. According to the *2012 International Arbitration Survey: Current and Preferred Practices in the*

[74] ibid.
[75] Hege Elizabeth Kjos, *Applicable law in investor-state arbitration. The interplay between national and international law* (Oxford 2013); Jeswald W. Salacuse, *The Three Laws of International Investment: National, Contractual, and International Frameworks for Foreign Capital* (Oxford 2013).
[76] UNCTAD 2014 Report 131.
[77] Concept Paper 11
[78] Chiara Giorgetti, 'Who decides who decides in international investment arbitration' (2014) 35 (2) University of Pennsylvania Journal of International Law 464.

Arbitral Process, seventy-six percent of respondents (from a group of 700 arbitration practitioners) find the arbitration model in which each party selects a co-arbitrator in a three-member arbitral tribunal to be the best one possible.[79]

Party-appointed arbitrators are nominated with the expectation that they understand the party's position; however, this does not mean that they are biased. Thus, in the authors' opinion, the parties' right to freely appoint their arbitrators best meets the needs of ISDS.

In this light, the proposal to create a roster limiting the choice of arbitrators to be appointed is of doubtful effect. Firstly, such a solution would obviously privilege responding states, which will have the possibility to establish a list of arbitrators in conformity with their own interests only.

Secondly, a roster consisting of a few individuals will drastically decrease the diversity of lawyers exercising real influence on the development of investment law. For example, Article 10.15(1) of EU-Singapore FTA requires the state-parties to the treaty to agree on 5 candidates from among whom the chairman of the tribunal will be chosen if the parties to the dispute cannot reach an agreement. Obviously, one can make an argument that such a pre-established list of persons to be appointed as arbitrators will result in greater predictability of their decisions. However, lack of diversity among arbitrators in ISDS is currently perceived as a real flaw in the system.[80]

The issue of arbitrators' remuneration should also be taken into account while assessing the Commission's ideas. If arbitrators were entitled to a salary just because of the fact that they are listed on the roster, it would result in significant expense for states concluding an investment treaty. On the other hand, the system of remuneration on a case-by-case basis does not eliminate the issue of conflicts of interest resulting from arbitrators practicing law at the same time. Thus, the goal of minimizing the connection between arbitrators and law firms seems to be either impossible or very costly. The authors believe that it is sufficient for the sake of due process if arbitrators' impartiality and independence are verified on the basis of standards such as those included in the widely-recognized *IBA Guidelines on Conflict of Interests in International Arbitration.*[81]

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[79] School of International Arbitration at Queen Mary University of London & White &Case, *2012 International Arbitration Survey" Current and Preferred Practices in the Arbitral Process*, http://annualreview2012.whitecase.com/International_Arbitration_Survey_2012.pdf, accessed on 8 October 2015.

[80] Albert Jan van den Berg, 'Dissenting Opinions by Party-Appointed Arbitrators in Investment Arbitration' in Mahnoush H. Arsanjani, Jacob Katz Cogan, Robert D. Sloane and Siegfried Wiessner (eds), *Looking to the Future: Essays on International Law in Honor of W. Michael Reisman* (Leiden, Boston 2010) 821, 834.

[81] http://www.ibanet.org/Publications/publications_IBA_guides_and_free_materials.aspx, accessed on 8 October 2015; See also Doak Bishop, 'Investor–State Dispute Settlement Under the Transatlantic Trade and Investment Partnership: Have the Negotiations Run Aground?' (2015) 30 (1) ICSID Review 3.

With regard to the qualifications of arbitrators listed in the roster, it is doubtful whether the qualifications required of arbitrators should be in any way connected to national law requirements for holding judicial office. Taking into consideration that these requirements were created for the sake of completely different adjudicatory process than ISDS, they do not provide any serious guarantees regarding the expertise and experience of arbitrators. Furthermore, in principle the authors accept the second proposal to require knowledge of international law from prospective arbitrators; however, it would be difficult to set out precise criteria enabling verification thereof.

As noted above, the Concept Paper states "that the EU should pursue the creation of one permanent court". This idea is currently under discussion also in the global context, which is reflected in the UNCTAD 2015 Report. Nevertheless, any attempt to institutionalize ISDS would have a severe impact on the level of investors' protection. It should be emphasized that arbitration was chosen as a primary method for ISDS because it provides a neutral forum free of national and political influence. The current proposal of the Commission, however, creates exactly the same risks which were supposed to be avoided by arbitration. Moreover, the idea to establish a permanent court for investment arbitration is burdened with the very same flaws as described above concerning the arbitrators' roster.

VIII. CONCLUSIONS

Investor-state dispute resolution system is a fundamental element of BITs. In principle, investment arbitration was supposed to be quicker, cheaper and more flexible than other methods of dispute resolution. However, the system also has its weaknesses, such as discrepancies in jurisprudence and lack of sufficient transparency, which are burdensome particularly for respondent states. Thus, a need for a change arose and resulted in ongoing debates concerning the future of investment arbitration and ISDS.

The Commission's work on the reform must in principle be assessed positively. The authors accept the general assumptions of the Concept Paper which aim at restoring the balance between the position of investors and states in investment disputes. However, they suggest a careful reconsideration of some ideas presented by the Commission in order to avoid a situation in which the proposed reform would lead to more preferential treatment of states in ISDS.

In particular, such a danger is present in respect of the proposal relating to the enhancement of states' right to regulate. In the authors' opinion, the Commission has not presented any solution regarding the problem observed in legal scholarship and jurisprudence concerning the demarcation of a line between non-compensable states' measures and a duty to compensate breaches of BITs. The proposal to preclude arbitrators from applying and interpreting domestic law is also controversial, and in the authors' view does not correspond to the current practice of investment arbitration. Similarly, the idea to change the current system of appointing arbitrators, and later on to create an international court for investment disputes, does not seem to have a justified basis. The current system of *ad hoc*

tribunals or tribunals established under the auspices of such investment centers as ICSID requires only improvements. The final thesis of the paper in this respect is that the aforementioned proposals are controversial, do not satisfy the expectations expressed by ISDS participants, and will possibly weaken the investment protection provided by international law, which would be contrary to the foundations of ISDS.

The second part of the final thesis is that introducing an appellate mechanism, enabling third parties to submit *amicus curiae* briefs, and eliminating the risk of parallel proceedings generally conform with the postulates expressed by the arbitration community and could help to restore the balance between states and investors. The appellate mechanism is expected to enhance the predictability of decisions reached in ISDS, whereas *amicus curiae* briefs can strengthen the transparency of the arbitration process.

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