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Towards a more diligent and sustainable system of investment protection

Legal briefing (version 2 - updated March 2019)



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Executive summary

This briefing assesses existing and proposed methods for reform of investor-state dispute settlement (ISDS) in the context of the ongoing discussions at the United Nations Commission on International Trade Law (UNCITRAL). The first section evaluates the EU's proposals for a Multilateral Investment Court (MIC), the second section then considers other alternatives to reform ISDS.

A. Assessment of the MIC and recommendations

The EU has recently made proposals for establishing a MIC. This would be a permanent body to replace the ad hoc ISDS mechanisms currently included in international investment agreements (IIAs).

This briefing identifies how the current proposals, despite making some procedural improvements, fail to adequately remedy systemic issues associated with existing ISDS mechanisms and the unbalanced privileges these systems afford to foreign investors.

This legal briefing sets out six key recommendations which UNCITRAL members and observers should take into account when considering whether the EU's proposal for a permanent MIC is a viable solution which will make the ISDS system sound and democratically accountable. These recommendations are:

1. **Necessity and desirability of ISDS system:** give greater consideration to the question of whether there is a real need for supranational ISDS mechanisms;
2. **Role of domestic institutions:** make investment law more respectful to domestic courts and institutions through a requirement to exhaust local remedies;
3. **Balance and participation:** ensure that the dispute settlement system is inclusive, and can receive not only investors' claims against states, but also claims made by states and affected third parties against investors;
4. **Protection of responsible investment:** limit the jurisdiction of the dispute settlement mechanism to claims by responsible investors who comply with domestic constitution and international standards of responsible investment, and exclude claims that target public interest legislation;
5. **Independence of adjudicators:** select and appoint members of the dispute settlement mechanism in full accordance with the Magna Carta of Judges and through an accountable and transparent process;
6. **Awards:** limit compensation amounts to cover only the value of proven economic damages resulting from the breach of the agreement exclude the expected profits from the calculation of compensation.

B. Alternative options

In terms of timing and effectiveness, a more viable option would be for states to withdraw their consent from ISDS and/or terminate all existing IIAs, and opt for already available alternatives for investment protection:

- 1. Withdrawal of consent and termination of IIAs;**
- 2. Strengthening domestic judiciary;**
- 3. Political risk insurance;**
- 4. Dispute prevention;**
- 5. State-to-state dispute settlement.**

Introduction

The investment law regime, and in particular the investor-state dispute settlement (ISDS) mechanism, has been subject to widespread criticism by civil society, governments and academics. In response to that, the European Commission announced in December 2016 that it would begin developing plans for a permanent Multilateral Investment Court (MIC). On 27 November 2017, the United Nations Commission on International Trade Law (UNCITRAL) Working Group III started discussing potential reform of the ISDS system, which provided the perfect forum for the EU to launch its initiative. After the European Commission obtained a mandate to negotiate the MIC in March 2018, the EU and its Member States officially submitted on 18 January 2019 its proposal to establish this MIC in the context of UNCITRAL.¹

This MIC, a permanent body with an appeal mechanism and full-time adjudicators, would potentially replace the ad hoc ISDS mechanisms currently included in international investment agreements (IIAs) and would have the power to hear claims on the basis of IIAs. ClientEarth believes that while the MIC makes some procedural improvements on how ISDS functions, it remains a threat to both the environment and democracy.

To help UNCITRAL members and observers decide on whether a potential future MIC is a viable solution which will make the system sound and democratically accountable, ClientEarth has developed six key recommendations (section A). The key recommendation to governments is to give greater consideration to the question of whether there is a real need for supranational ISDS mechanisms. If governments consider that ISDS is necessary, ISDS reforms could take the form of a MIC, but this reform would need to incorporate a number of features in order credibly to improve the fairness and inclusiveness of ISDS. For instance, reforms must promote greater reliance on domestic courts and alternative forms of investment protection, create space for third parties to participate in proceedings, ensure that investors are not given more rights than other citizens, and prevent irresponsible investors from benefiting from the system.²

However, for governments who consider that ISDS is not necessary and that the MIC does not offer a credible and timely reform, a more viable policy option would be to terminate existing IIAs altogether and opt for readily available alternatives for protecting investment (section B).

A. Assessment of the MIC and recommendations

The EU views the MIC as “the only reform option that can effectively respond to all the concerns identified in this UN process”³ Yet, the concerns explored so far by the Working Group III relate only to consistency, coherence, and predictability; impartiality and independence of arbitrators; and cost and duration. They do not properly reflect the wide range of concerns that have been expressed by a number of governments and need further consideration: lack of obligations on

¹ Submission of the European Union and its Member States to UNCITRAL Working Group III, 18 January 2019, Establishing a standing mechanism for the settlement of international investment disputes http://trade.ec.europa.eu/doclib/docs/2019/january/tradoc_157631.pdf

² This briefing is an updated version of ClientEarth's response to the initial European Commission's consultation on plans for a multilateral investment court: Laurens Ankersmit, Towards a more diligent and sustainable system of investment protection, ClientEarth, 13 April 2017, <https://www.documents.clientearth.org/library/download-info/towards-a-more-diligent-and-sustainable-system-of-investment-protection/>

³ Submission of the EU, op. cit.

foreign investors, regulatory chill and impacts on the right to regulate in the public interest and achieve sustainable development outcomes, relationship with domestic law and domestic courts, and asymmetry of the system.

Although there are some encouraging procedural improvements envisaged in the MIC, these are far from being sufficient to address the deep flaws of ISDS. Such a reform would therefore risk being mere window dressing with a few cosmetic changes. It would vastly expand and legitimise a system which is currently one-sided, and completely oblivious to the importance of domestic courts. This is particularly true in the absence of both meaningful reforms to IIA substantive rules and new protections for the rights and interests of other stakeholders affected by the investment disputes.

It should also be noted that the MIC's ability to solve the problem of inconsistency of arbitral decisions remains uncertain since the different wording of provisions in the IIAs may lead to competing interpretations. It could also result in significant disagreements if certain interpretations developed on the basis of substantive provisions in one IIA, are applied to other agreements for which parties had other intentions. In addition, the appeal mechanism could have the effect of endorsing questionable decisions. This could be especially dangerous if tribunal members are drawn from the existing circle of investment lawyers, who have so far driven the boom of the arbitration industry and tend to favour investors.

Moreover, the MIC attracts only a certain number of States and will only cover a limited number of IIAs. Some major capital exporting states have already expressed they would not support such a proposal. It will therefore only be a partial solution to the problem, and investors are likely to do "treaty shopping" by structuring their investments in states not party to this new instrument.

Section 1 explains why it is necessary in the first place to question the necessity and desirability of the ISDS system. Sections 2 to 6 provide recommendations in the light of which governments are invited to assess whether the MIC will fully address the deep flaws of the existing system.

1 Necessity and desirability of ISDS system

Recommendation 1: give greater consideration to the question of whether there is a real need for supranational ISDS mechanisms and how beneficial they actually are for host states

A key preliminary question that needs to be answered is whether specialized supranational investor protection mechanisms are desirable or necessary in the first place. There is growing evidence that the benefits traditionally associated with ISDS are not as clear or as significant as often presumed.⁴ In the light of this, governments must not rush too quickly into assuming that ISDS mechanisms must be a part of their country's investment agreements.

To begin with, policymakers and legislators should be mindful of the origins of the system of investment protection. As noted by Peter Muchlinski, a professor in International Commercial Law:

⁴ Joachim Pohl, "Societal benefits and costs of International Investment Agreements: A critical review of aspects and available empirical evidence" OECD Working Papers on International Investment, 2018/01, OECD Publishing, Paris

“the existing system of ISDS is largely an unforeseen historical accident, developed as an act of legal entrepreneurship by specialist lawyers. It was never seen as a general substitute for domestic legal dispute settlement, but as a stopgap in cases of extreme maladministration carried out by governments in weak governance zones. [T]he availability of ISDS in IIAs was also very much involved with the decolonisation process and was rooted in the mistrust placed in early postcolonial governments’ ability to offer impartial justice to foreign investors, and their habitual disregard for the procedures of ad hoc international arbitration.”⁵

The accidental origins of ISDS have led directly to many of the problems with the current system. The system was based on commercial arbitration. It gives transnational corporations special rights - but no responsibilities - for their activities in another country, and allowed these companies to completely side-line the domestic judicial process.⁶ Arbitrators are given a financial incentive to claim jurisdiction over cases and the more expansive their interpretation of IIAs became, the bigger the incentive for investors and their lawyers to bring cases before investment tribunals.⁷

The one-sided nature of the system has greatly contributed to its rapid expansion in the past twenty years. The first ISDS case was filed in 1987 and fewer than 50 cases had been filed up to 2000.⁸ However, as of February 2019, 904 known ISDS cases have been filed and at least 138 states have faced formal claims.⁹

In light of what ISDS has become, an increasing number of countries are reconsidering their approach to investment protection and are in the process of terminating or revising their IIAs. Countries reconsidering their approaches and terminating their agreements include key global economies like Indonesia, India, and South Africa.¹⁰ Moreover, in evidence to the US House Ways and Means Committee in March 2018, US Trade Representative, Robert Lighthizer expressed strong scepticism about ISDS. This position is realised in the draft text of United States-Mexico-Canada Agreement (USMCA) (successor to the North American Free Trade Agreement (NAFTA)). Other countries such as New Zealand and Brazil have refused to include ISDS in their international investment agreements.¹¹ In a landmark ruling, the Court of Justice of the European

⁵ Peter Muchlinski, 'Regulating Multinational Enterprises' in Marc Bungenberg and others (eds), *European Yearbook of International Economic Law 2016* (Springer 2016), 391-422, at 416. See also Kenneth J. Vandeveld, 'A brief history of International Investment Agreements' 12 *U.C.-Davis Journal of International Law & Policy* 157 (2005), available at <http://ssrn.com/abstract=1478757>; Muthucumaraswamy Sornarajah, 'International Investment Law as Development Law: The Obsolescence of a Fraudulent System' Marc Bungenberg and others (eds), *European Yearbook of International Economic Law 2016* (Springer 2016), 209-232

⁶ Gus van Harten, *Investment treaty arbitration and public law* (Oxford: Oxford University Press, 2007)

⁷ *Ibid.*

⁸ Data obtained from <https://investmentpolicyhub.unctad.org/ISDS/FilterByYear> (accessed 27 February 2019)

⁹ Data obtained from <https://investmentpolicyhub.unctad.org/ISDS/> (accessed 27 February 2019)

¹⁰ Ecuador decided to renounce the ICSID Convention, India has recently sought to terminate 57 of its BITs (see Kavaljit Singh and Burghard Ilge 'India overhauls its investment treaty regime', *Financial Times Blog* 15 July 2016), Indonesia has announced that it will terminate or renegotiate its IIAs, terminating at least ten of them, with likely another eleven to follow (see Michael Ewing-Chow, 'Indonesia to terminate' *Financial Times* 26 March 2014 and Juniate Losari, 'Indonesia is letting its bilateral treaties lapse so as to renegotiate better ones' *Financial Times* 15 April 2014), and for South Africa see Adam Green, 'South Africa: The BITS in Pieces' *Financial Times* 19 October 2012

¹¹ Rt Hon Jacinda Ardern commented "Cabinet has today instructed trade negotiation officials to oppose ISDS in any future trade agreements" in her speech 'Foreign speculators house ban' (31 October 2017) available at <https://www.beehive.govt.nz/release/foreign-speculators-house-ban> (accessed on 27 February 2019). Fabio Morosini and Michelle Raton Sanchez Badin, 'The Brazilian Agreement on Cooperation and Facilitation of Investments (ACFI): A New Formula for International Investment Agreements?' *Investment Treaty News* (4 August 2015) available at <https://www.iisd.org/itn/2015/08/04/the-brazilianagreement-on-cooperation-and-facilitation-of-investments-acfi-a-new-formula-for-international-investment-agreements/>

Union (CJEU) found that ISDS provisions in intra-EU bilateral investment treaties (BITs) are incompatible with EU law on the basis that they remove disputes from the jurisdiction of EU courts.¹² This decision has led the EU Member States to commit themselves to the termination of all intra-EU BITs by means of a plurilateral treaty.¹³ An opinion of the CJEU on the compatibility of the ISDS provisions with EU law in the context of an EU-third country agreement (Opinion 1/17 on CETA) is expected soon. In this context, it is doubtful whether further expansion of this post-colonial system to global dimensions is warranted or justifiable and whether the system should not simply be phased out.

1.1 Necessity of ISDS mechanisms

The Commission's main argument for the development of the MIC is that "international investment rules and international investment dispute settlement have a role to play in encouraging and retaining investment".¹⁴ However, studies remain inconclusive as to whether ISDS in fact helps to attract investment. Whilst some studies do show correlation between investment treaties and investment flows, these findings are inconclusive – correlation does not prove causation. Further research instead shows that investment decisions are largely based on factors such as market size and growth; infrastructure quality; level of education of the population; tax rates; and other regulatory policies.¹⁵ Indeed, "[i]t is clear, then, that no individual factor, such as an investment treaty, could move FDI flows by itself".¹⁶

Furthermore, ISDS covers all types of FDI, without taking into account its quality, or whether it promotes sustainable development. The benefits associated with FDI depend on the specific nature, form and purpose of the proposed investment. Indeed, in certain circumstances, FDI can have negative impacts for host states leading to labour and environmental exploitation; stifling domestic businesses and exacerbating corruption.¹⁷ States should therefore be careful not to seek FDI at any cost, notably by agreeing to controversial ISDS provisions which risk to attract undesirable FDI by speculative investors or vulture funds.

These findings are borne out in practice. Countries such as Indonesia, South Africa, Bolivia and India that have moved away from ISDS have not experienced corresponding decline in foreign direct investment (FDI).¹⁸ For instance, FDI into India in 2017 created the most jobs (161,445) in

¹² Case C-284/16 *Slovak Republic v Achmea BV* (6 March 2018).

¹³ Declaration of the Member States of 15 January 2019 on the legal consequences of the Achmea judgment and on investment protection, https://ec.europa.eu/info/publications/190117-bilateral-investment-treaties_en

¹⁴ European Commission, 'The Multilateral Investment Court project' available at <http://trade.ec.europa.eu/doclib/press/index.cfm?id=1608> (accessed on 13 March 2017)

¹⁵ Lisa E Sachs and Karl P Sauvart, 'BITs, DTTs, and FDI flows: An Overview' in Sauvart and Sachs (eds), *The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties, and Investment Flows* (Oxford University Press 2009). Lauge Skovgaard Poulsen, 'The Importance of BITs for Foreign Direct Investment and Political Risk Insurance: Revisiting the Evidence,' in: K. Sauvart, ed., *Yearbook on International Investment Law & Policy 2009/2010* (New York: Oxford University Press, 2010)

¹⁶ Lisa E Sachs and Karl P Sauvart, 'BITs, DTTs, and FDI flows: An Overview' in Sauvart and Sachs (eds), *The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties, and Investment Flows* (Oxford University Press 2009).

¹⁷ Columbia Center on Sustainable Investment, 'Costs and Benefits of Investment Treaties: Practical Considerations for States' (March 2018), page 8

¹⁸ Columbia Center on Sustainable Investment, 'Costs and Benefits of Investment Treaties: Practical Considerations for States' (March 2018); IIAs by Economy: South Africa available at <https://investmentpolicyhub.unctad.org/IIA/CountryBits/195#iialInnerMenu> (accessed on 28 February 2019); fDI Intelligence, 'The fDi Report 2018: Global Greenfield investment trends' (2018) available at <http://report.fdiintelligence.com/> (accessed 28 February 2019)

the whole of the Asia-Pacific region, after announcing early 2016 that it would terminate its BITs with 58 governments.¹⁹ Ireland, an EU Member State that attracts considerable amounts of foreign direct investment,²⁰ is only party to one international investment agreement with ISDS: the Energy Charter Treaty. Moreover, evidence suggests that foreign firms are treated as well, if not better, than domestic firms in host countries.²¹

In addition, most domestic legal systems already offer adequate protection for investors, making it difficult to justify such a potentially expensive and far-reaching system.²² Recognizing this, the Australia–United States Free Trade Agreement excluded ISDS from its investment chapter, because the parties concluded that this was unnecessary in light of the adequacy of both countries' judiciary systems.²³ Indeed the United States Trade Representative noted on this:

*"[a]mong other things, Australia has an open economic environment and a legal system similar to that of the United States, U.S. investors have confidence in the fairness and integrity of Australia's legal system, and the United States has a long history of close commercial relations with Australia that has flourished largely without disputes of the type addressed by international investment provisions."*²⁴

1.2 Desirability of ISDS mechanisms

The claim that ISDS is necessary in order to secure FDI is clearly unsubstantiated. In addition to being unnecessary, ISDS can have negative impacts for host states making it undesirable.

First, costs of defending itself in ISDS cases are significant for states, in particular for developing countries. According to studies, parties' costs usually amount to around USD 5 million, but can go well beyond this average figure. Most of the time, a government has to pay its legal expenses even if it successfully defended its case. Moreover, in a number of disputes, compensations of legal expenses and costs to states remain unpaid by investors. This requires additional time and resources from the state to enforce its action.²⁵

Second, there is evidence indicating that ISDS can in fact have a negative impact on levels of investment. This is the "reputational cost". Just the initiation of an ISDS case against a state can lead to reputational damage and declining investment in that state. In the event that a country

¹⁹ fDI Intelligence, 'The fDi Report 2018: Global Greenfield investment trends' (2018) available at <http://report.fdiintelligence.com/> (accessed 28 February 2019)

²⁰ Ireland is listed as 9th biggest recipient worldwide of FDI by the United States Central Intelligence Agency, see CIA world factbook at <https://www.cia.gov/library/publications/the-world-factbook/geos/ei.html> (accessed on 13 March 2017)

²¹ Emma Aisbett and Louge Poulsen, 'Relative Treatment of Aliens: Firm-level Evidence from Developing Countries' GEC Working Paper 122 (December 2016)

²² Gus Van Harten, 'Key Flaws in the European Commission's Proposals for Foreign Investor Protection in TTIP', Osgoode Legal Studies Research

Paper No. 16/2016, 2-7

²³ Jan Kleinheisterkamp and Lauge N. Skovgaard Poulsen, 'Investment Protection in TTIP: Three Feasible Proposals' in Marc Bungenberg and others

(eds), *European Yearbook of International Economic Law 2016* (Springer 2016), 527-542, at 533-535

²⁴ The statement can be found at page 5-6 of the report of the statements made by the US Trade Representative: https://ustr.gov/archive/assets/Document_Library/Reports_Publications/2005/2005_TPA_Report/asset_upload_file120_7517.pdf (accessed on 14 March 2017)

²⁵ Columbia Center on Sustainable Investment, 'Costs and Benefits of Investment Treaties: Practical Considerations for States' (March 2018), page 11

loses an ISDS case, the resulting reduction in investment is even greater.²⁶ Third, by providing a mechanism for investors to challenge domestic law and regulation, ISDS encroaches on governments' sovereignty and policy space including in crucial areas such as environmental and public health protections. In this way, the inclusion of ISDS provisions can lead to regulatory chill: where states are discouraged from introducing or encouraged to revoke or dilute regulations because of the risk or initiation of legal action by an investor before an ISDS tribunal. There is a growing body of evidence demonstrating this²⁷ and governments participating in the UNCITRAL reform talks have raised regulatory chill as a concern.²⁸

The system has given rise to an increasing number of claims that target public interest measures, such as tobacco-control legislation,²⁹ a nuclear power phase-out,³⁰ refusal of permits relating to cyanide-based open pit gold-mine³¹ an oil pipeline,³² a coal-fired power plant,³³ and a moratorium on fracking.³⁴ Considering the significant amounts of money involved, ISDS has given transnational corporations an unprecedented powerful tool to put pressure on domestic public-interest decision-making.³⁵ This risk is particularly acute for developing countries whose legal systems and public-interest policies are continuing to mature.³⁶

Fourth, ISDS may have perverse effects on the development of independent and strong judicial systems in countries that currently face rule of law challenges. If access to justice is a driver for attracting FDI, then countries have an incentive to improve local court systems. Transferring investment disputes out of the jurisdiction of local courts to supranational ISDS fora removes the economic incentive for developing a strong and independent domestic judiciary. In other words, the existence of ISDS risks taking away a potential economic incentive to developing a strong and independent domestic judiciary.

2 Role of domestic institutions

Recommendation 2: make investment law more respectful to domestic courts and institutions through a requirement to exhaust local remedies

²⁶ Todd Allee and Clint Peinhardt, 'Contingent Credibility: The Impact of Investment Treaty Violations on Foreign Direct Investment' (2011) 65 International Organization 401

²⁷ See, for instance, Gus van Harten and Dayna Nadine Scott, 'Investment Treaties and the Internal Vetting of Regulatory Proposals: A Case Study from Canada' (2016) 7 Journal of International Dispute Settlement 92; Jane Kelsey, "Regulatory chill: learnings from New Zealand's plain packaging tobacco law" QUT Law Review, 17(2) 2017; Kyla Tienhaara, 'Regulatory Chill in a Warming World: The Threat to Climate Policy Posed by Investor-State Dispute Settlement' (2017) 7 Transnational Environmental Law 229. In 2014, Toby Landau, a leading arbitration lawyer, told an Australian radio programme: "Without a doubt. Regulatory chill, so-called, in my opinion definitely exists, and there's palpable evidence of it. There are those who deny it, but I can say that, in my role as counsel, on a number of occasions now, I've actually been instructed by governments to advise on possible adverse implications or consequences of a particular policy in terms of investor-state cases."

²⁸ Gus Van Harten, Jane Kelsey and David Schneiderman, 'Phase 2 of the UNCITRAL ISDS Review: Why 'Other Matters' Really Matter' (2019) All Papers 328

²⁹ Philip Morris Brands Sàrl, Philip Morris Products S.A. and Abal Hermanos S.A. v. Oriental Republic of Uruguay, ICSID Case No. ARB/10/7; Philip Morris Asia Limited v. The Commonwealth of Australia, UNCITRAL, PCA Case No. 2012-12

³⁰ Vattenfall AB and others v. Federal Republic of Germany, ICSID Case No. ARB/12/12

³¹ Gabriel Resources Ltd. and Gabriel Resources (Jersey) v. Romania, ICSID Case No. ARB/15/31

³² TransCanada Corporation and TransCanada PipeLines Limited v. The United States of America

³³ Vattenfall AB, Vattenfall Europe AG, Vattenfall Europe Generation AG v. Federal Republic of Germany, ICSID Case No. ARB/09/06

³⁴ Lone Pine Resources Inc. v. The Government of Canada, ICSID Case No. UNCT/15/2

³⁵ Gus van Harten, Investment treaty arbitration and public law (Oxford: Oxford University Press, 2007)

³⁶ Columbia Center on Sustainable Investment, 'Costs and Benefits of Investment Treaties: Practical Considerations for States' (March 2018)

As noted above, the entire transfer of disputes out of the jurisdiction of domestic legal systems does not serve these systems. Instead, it undermines them. It does not help to build their capacity, develop domestic rule of law or enhance their reputations as legitimate fora for dispute resolution.

If governments decide that ISDS is necessary, a key objective must be ensuring that investment law is respectful of domestic courts and institutions. In order to do this, it should be required to exhaust local remedies before bringing a claim at the international level. This would bring investment law back in line with customary international law and international human rights law. Second, domestic courts or authorities of the host state should be involved for matters of domestic law. This would ensure proper guidance on how domestic law should be understood.

2.1 Exhaustion of local remedies

Under both customary international law and international human rights law, individuals are required to seek redress before domestic courts before bringing international proceedings against the state for wrongful acts.³⁷ This requirement is known as the ‘exhaustion of local remedies’ (ELR) rule. The ELR rule is there to make sure that states have an opportunity to remedy wrongful acts through their own court systems before disputes are taken to the international level. International tribunal can then rely on the national record to conduct its own review if relevant. Moreover, for foreign nationals, the ELR duty reflects the idea that their choice to enter a country carries a responsibility to accept domestic laws and institutions; thus conveys that no one is above the law.³⁸ ELR therefore safeguards the powers of domestic courts, and by extension the sovereignty of the state.³⁹

In two cases involving treatment of foreign companies by their host states, the International Court of Justice (ICJ) laid down key aspects of the ELR rule. In *Interhandel*, the ICJ found that the ELR requirement “is a well-established rule of customary international law” that gives “the State where the violation occurred [...] an opportunity to redress it by its own means, within the framework of its domestic legal system”.⁴⁰ The ELR rule applies whenever international and domestic proceedings “are designed to obtain the same result.”⁴¹ In a second case, *ELSI*, the ICJ further clarified that for the ELR rule to apply “it is sufficient if the essence of the claim has been brought before the competent tribunals and pursued as far as permitted by local law and procedures, and without success.”⁴² The ICJ also found in *ELSI* that the ELR rule is so important that it cannot be construed as having been implicitly set aside through an international agreement.⁴³

³⁷ Martin Dietrich Brauch, 'IISD Best Practices Series: Exhaustion of Local Remedies in International Investment Law' (IISD, January 2017) available at <https://www.iisd.org/library/iisd-best-practices-series-exhaustion-local-remedies-international-investment-law> (accessed on March 14 2017)

³⁸ Gus Van Harten, Jane Kelsey and David Schneiderman, 'Phase 2 of the UNCITRAL ISDS Review: Why 'Other Matters' Really Matter (2019) All Papers 328

³⁹ The ELR rule is similar, in that sense, to both the principle of subsidiarity and the aforementioned Article 1 of the TEU, which provides that “decisions are taken as openly as possible and as closely as possible to the citizen.”

⁴⁰ *Interhandel* (Switz. v. U.S.), Preliminary Objections, 1959 I.C.J. Rep. 6, at 27 (Mar. 21). Available at <http://www.icj.org/docket/files/34/2299.pdf> (accessed on 14 March 2017), at 27

⁴¹ *Ibid*

⁴² See Brauch *supra* n 26; *Elettronica Sicula S.p.A. (ELSI)* (Italy v. U.S.), Judgment, 1989 I.C.J. Rep. 15, 28 I.L.M. 1109 (July 20), para. 59

⁴³ *Ibid.*, para. 50

The ELR requirement can also be found in all the major international and regional human rights systems. The European Court of Human Rights, for example, “may only deal with the matter after all domestic remedies have been exhausted, according to the generally recognised rules of international law, and within a period of six months from the date on which the final decision was taken.”⁴⁴ Similarly, the International Covenant on Civil and Political Rights, the American Convention on Human Rights, and the African Charter on Human and Peoples’ Rights all contain ELR rules.⁴⁵ The only requirement for the ELR rule is the availability of effective and adequate or sufficient remedies in domestic law.

International investment law, by contrast, usually does not follow the ELR rule. This practice is in fact so well established that the International Law Commission (ILC) has noted that IIAs “abandon or relax the conditions relating to the exercise of diplomatic protection, particularly the rules relating to [ELR]”.⁴⁶

There are a few IIAs that do explicitly require ELR, including those of several Member States.⁴⁷ Moreover, recently countries and regional economic communities such as Argentina, India, Turkey, the United Arab Emirates, Uruguay, the Southern African Development Community (SADC), and the East African Community (EAC) have begun to insist that investors either pursue or exhaust local remedies before having recourse to international forms of dispute settlement.⁴⁸

Most IIAs, however, do not require ELR. IIAs eliminate the ELR requirement in several ways. Some IIAs explicitly depart from the ELR rule by providing that consent to arbitration implies that the Parties to the agreement have renounced or waived ELR for the purpose of the agreement.⁴⁹ Some agreements, such as the EU-Canada Comprehensive Trade and Investment Agreement (CETA), contain a tacit waiver by requiring investors to drop the pursuit of local remedies when they bring a claim before a CETA tribunal.⁵⁰

However, most IIAs remain silent on the issue.⁵¹ Where an IIA is silent, investment arbitrators have often interpreted this silence in a way that eliminates ELR requirements, and expands their own jurisdiction to hear claims to cases where investors have not exhausted all local remedies. This is in direct contradiction to the principle under the ICJ’s *ELSI* decision that ELR is so important that

⁴⁴ Article 35 (1) ECHR, available at http://www.echr.coe.int/Documents/Convention_ENG.pdf (accessed on 14 March 2017)

⁴⁵ Article 41 (1) (c) of the International Covenant on Civil and Political Rights, available at <http://www.ohchr.org/Documents/ProfessionalInterest/ccpr.pdf> (accessed on 14 March 2017); Article 46 (1) (a) of the American Convention on Human Rights available at <http://www.cidh.org/Basicos/English/Basic3.American%20Convention.htm> (accessed on 14 March 2017); fef Article 56 (5) of the African (Banjul) Charter on Human and People’s Rights available at http://www.achpr.org/files/instruments/achpr/banjul_charter.pdf (accessed on 14 March 2017) ³³ See Brauch supra n 26 at 5-6

⁴⁶ In fact, the ILC proposed that the draft articles on diplomatic protection “do not apply to the extent they are inconsistent with special rules of international law, such as treaty provisions for the protection of investments.” See article 17 of the 2006 Draft articles on Diplomatic Protection available at legal.un.org/ilc/texts/instruments/word_files/english/draft_articles/9_8_2006.doc (accessed on 14 March 2016)

⁴⁷ See for instance the recent Albania- Lithuania Bilateral Investment Treaty and the Romania - Sri Lanka Bilateral Investment Treaty. See Brauch supra n 26 at 7-8

⁴⁸ For the difference in pursuit or exhaust local remedies see Brauch supra n 26 at 9-10

⁴⁹ See for instance article 11 (4) of the BIT between the Czech Republic and Saudi Arabia, available at <http://investmentpolicyhub.unctad.org/Download/TreatyFile/978>

⁵⁰ Article 8.22 (f) and (g) of the Comprehensive Economic and Trade Agreement (CETA) between Canada, of the one part, and the European Union and its Member States, of the other part (2017) OJ L 11/23

⁵¹ See Brauch supra n 26 at 9-10

it cannot be construed as being implicitly set aside by international agreements.⁵² In particular, arbitrators interpreted article 26 of the International Centre for Settlement of Investment Disputes (ICSID) Convention as not requiring ELR. Article 26 of the ICSID provides that:

“Consent of the parties to arbitration under this Convention shall, unless otherwise stated, be deemed consent to such arbitration to the exclusion of any other remedy. A Contracting State may require the exhaustion of local administrative or judicial remedies as a condition of its consent to arbitration under this Convention.”

This provision has been interpreted as meaning “that there is no need to exhaust domestic procedures before initiating ICSID arbitration, unless otherwise stipulated.”⁵³ But this is not clear from the provision: article 26 could also be interpreted (in accordance with *ELSI*) to mean that ELR applies unless states explicitly agree that it does not. Given these two choices, arbitration tribunals have gone with the former interpretation over the latter one, construing article 26 of the ICSID Convention to be an explicit waiver.⁵⁴

Arbitrators have also done away with the ELR rule in cases that do not fall under the ICSID Convention.⁵⁵ For example, in *Nykomb v. Latvia*, a case under the Energy Charter Treaty, the arbitration tribunal stated, shockingly, that “no such general obligation to exhaust local remedies can be derived from [...] international law in general.”⁵⁶

Given this trend of failure to apply the ELR rule in IIAs, it is paramount to ensure the inclusion of an explicit ELR requirement. The ELR requirement could be drawn from one of the IIAs and model IIAs that do have such a provision.⁵⁷ It is important that the ELR requirement is drafted broadly to require the exhaustion of both administrative and judicial procedures in the relevant state. For instance, an ELR rule could be formulated in the following way:

Example of an exhaustion of local remedies rule

"A state party, an investor, or an affected third party must exhaust local administrative and judicial remedies before it may submit a claim before the Multilateral Investment Court seeking damages for an alleged breach of an International Investment Agreement."

The ELR rule is attacked by some critics on the basis that some countries have inefficient, weak or corrupt judicial systems and so it is inappropriate and undesirable to require foreign investors to exhaust local remedies. However, this is clearly not the case for all domestic legal systems. In the absence of an ELR requirement, investors have the sole discretion to assess the reliability and suitability of local remedies and determine whether or not to use them without needing to provide an explanation.

⁵² Elettronica Sicula S.p.A. (ELSI) (Italy v. U.S.), Judgment, 1989 I.C.J. Rep. 15, 28 I.L.M. 1109 (July 20), para. 50

⁵³ Lanco International Inc. v. Argentine Republic, ICSID Case No. ARB/97/6, Preliminary Decision on Jurisdiction, para. 37

⁵⁴ See Brauch supra n 26 at 15

⁵⁵ Ibid.

⁵⁶ Nykomb Synergetics Technology Holding AB v. The Republic of Latvia, SCC, award of 16 December 2003

⁵⁷ See for instance article 14.3 of the India Model Bilateral Investment Treaty available at

https://www.mygov.in/sites/default/files/master_image/Model%20Text%20for%20the%20Indian%20Bilateral%20Investment%20Treaty.pdf (accessed on 14 March 2017) and article 29 (4) (a) of the Model BIT of the Southern African Development Community available at <http://www.iisd.org/itn/wpcontent/uploads/2012/10/sadc-model-bit-template-final.pdf> (accessed on 14 March 2017)

In addition, the notion that replacing weak domestic courts with international arbitration tribunals ensures fair, independent and transparent decision-making is fallacious.⁵⁸ ISDS is systematically biased towards investors because of its inherent asymmetrical nature. It lacks openness and relies on procedures that fail to properly secure the rule of law. These issues are not addressed by the proposed MIC.

Moreover, the fact that some countries' legal systems may not yet be sufficiently robust is not a knockout blow for the ELR rule. To overcome this, the ELR rule may be qualified with exceptions recognised under international law. In both customary international law and international human rights law, there are certain exceptions to ELR and these principles could be reflected in the context of international investment law. For example, parties could be exempted from ELR requirements where domestic remedies are not reasonably available. This would be in keeping with new generation agreements like the SADC Model BIT, under which there is no need to exhaust domestic remedies if the investor establishes that "there are no reasonably available domestic legal remedies capable of providing effective relief for the dispute concerning the underlying measure, or that the legal remedies provide no reasonable possibility of such relief in a reasonable period of time."⁵⁹ To promote certainty and clarity, these exceptions should be clearly specified within the text of the agreement. They would need to establish safeguards and a defined process to determine whether domestic remedies are reasonably available, in order to prevent the risk that tribunals would be quick to find that the exemptions did apply so that more cases would fall within the jurisdiction of the tribunal.

The inclusion of an ELR requirement can be procedurally advantageous. In *Vattenfall II v Germany*, Vattenfall registered its claim with ICSID in May 2012 and, at the time of writing – just under 7 years later in March 2019 – no decision has been handed down.⁶⁰ Vattenfall also commenced domestic proceedings in the German Federal Constitutional Court. This court gave judgment in December 2016 – just under four and a half years after proceedings in that forum started. It is not the case that domestic legal systems are always less efficient than international arbitration.

Including an ELR rule will ensure that investment law will be consistent with international human rights law and customary international law. If ordinary citizens, almost always with far more limited resources than transnational corporations using IIAs, are required to exhaust domestic remedies, foreign investors should at least be required to do the same. Not including an ELR rule would therefore send a wrong signal that investor rights are procedurally more important than human rights.

2.2 Involvement of domestic institutions for questions of domestic law

A second important issue relating to the relationship with domestic courts is how the MIC should deal with matters of domestic law. Investment arbitrators are generally specialists in international

⁵⁸ Gus Van Harten, Jane Kelsey and David Schneiderman, 'Phase 2 of the UNCITRAL ISDS Review: Why 'Other Matters' Really Matter (2019) All Papers 328

⁵⁹ Article 15 of the Model BIT of the Southern African Development Community available at <http://www.iisd.org/itn/wp-content/uploads/2012/10/sadcmmodel-bit-template-final.pdf> (accessed on 14 March 2017)

⁶⁰ As noted on <https://investmentpolicyhub.unctad.org/ISDS/Details/467> (accessed on 27 February 2019)

investment law, and are unlikely to be familiar with the intricacies of a domestic legal system. For example, CETA sets the following requirements for members of its investment Tribunal:

“The Members of the Tribunal... shall have demonstrated expertise in public international law. It is desirable that they have expertise in particular, in international investment law, in international trade law and the resolution of disputes arising under international investment or international trade agreements.”⁶¹

CETA therefore does not require tribunal members to have any expertise in matters of domestic law, environmental law, social law, human rights law or any other field of law that covers legitimate public interests of importance to local communities. In fact, one of the major objections against the investment protection regime is that it removes decision-making from local communities.⁶² As Professor Martti Koskenniemi has argued:

“The main issue is really not about whether to decide in favour of investor interests or countervailing values. It is instead, whether to protect the autonomous power of domestic political communities or to let the conditions of local lives be decided in the (‘disembedded’) processes of economic globalization.”⁶³

In order to be respectful of domestic political communities, it is necessary to defer to domestic authorities on matters of domestic law. Domestic institutions are well-placed to interpret and apply the domestic laws of the host. However, investment arbitrators are inexperienced with local legal systems and are not experts in the policy areas they may be called on to interpret. Only by requiring them to defer to local authorities can it be assured that they do not incorrectly read or apply domestic rules, or subordinate unfamiliar social and environmental interests to familiar investment ones.

Inspiration for this requirement can be taken from the draft agreement providing for the accession of the European Union to the European Convention on Human Rights. Following this text, a provision could require the prior involvement of the CJEU for questions of both primary and secondary EU law, and similar rules would apply for domestic institutions regarding domestic questions.⁶⁴ In some cases, the possibility for prior involvement of domestic courts on questions of domestic law might be technically problematic and may require further investigation.

⁶¹ CETA 8.27 (4)

⁶² Martti Koskenniemi, "It's not the Cases, It's the System: M. Sornarajah, Resistance and Change in the International Law on Foreign Investment
Cambridge: Cambridge University Press, 2015. Pp. xx + 437. £80. ISBN 9781107096622' (2017) Journal of World Investment & Trade, 343 – 353, at 343

⁶³ Ibid.

⁶⁴ As discussed above in section 1, the CJEU has held that ISDS mechanisms in intra-EU investment agreements are incompatible with EU law because ISDS has an “adverse effect on the autonomy of EU law. An ISDS arbitral tribunal may be required to interpret or apply EU law but as it is not a “court or tribunal of a Member State” it is not entitled to use the preliminary ruling procedure i.e. the “keystone” of the EU’s judicial system.” A CJEU opinion on the compatibility of ISDS provisions with EU law in EU-third country investment agreement is expected soon. For proponents of the MIC, an advantage of requiring ELR; involvement of domestic institutions in interpreting domestic law and early involvement of the CJEU is that these provisions could help to prevent the MIC from being found incompatible with the EU Treaties.

3 Balance and participation

Recommendation 3: ensure that the dispute settlement mechanism is inclusive, and can receive not only investors' claims against states, but also counterclaims made by states against investors and ensure full participation of affected third parties.

Another issue of concern UNCITRAL members and observers must take into account when considering the reforms, relates to the fairness and inclusiveness of investment arbitration. Fair dispute settlement processes must ensure that everyone who is affected by proceedings shall have standing before the relevant court or tribunal. If this is not possible, an adjudicator cannot make a balanced judgment on the basis of all the relevant facts. The result will not be properly informed and risks being uneven.

ISDS provides a forum for investors to pursue their complaints regarding the behaviour of host states. However, most IIAs (including CETA⁶⁵) do not permit states or affected third parties to bring claims against investors or to meaningfully intervene. ISDS is therefore a lopsided procedure that unevenly privileges investors' rights over the rights of people and their governments. Moreover, the limited possibility of participation by affected third parties does not allow those individuals and organisations to have a say in cases that may have significant consequences for their interests.

Some IIAs attempt to make ISDS slightly fairer by allowing states to bring counterclaims against investors for any breach of their obligations. The possibility for counterclaims by states may be either expressly provided for in the IIA (an example is the 2015 India BIT), or may be inferred from the language of the IIA. For instance, arbitrators in the recent *Urbaser v Argentina* case interpreted the Spain-Argentina BIT's rules on who can bring a claim as implicitly permitting counterclaims by the state on the basis of human rights violations.⁶⁶

Urbaser v Argentina: a counterclaim based on the right to water⁶⁷

Urbaser was a shareholder in a utility company that supplied water and sewage services in Buenos Aires. The utility company went bankrupt in the wake of Argentina's financial crisis in the early 2000s, and blamed its losses on Argentina's actions during the crisis period. Urbaser sued Argentina for various breaches of the Spain-Argentina BIT as a result.

Argentina filed a counterclaim, arguing that the utility company's failure to provide services violated the human right to water.

Urbaser objected to this, arguing that Argentina couldn't make such a counterclaim because the BIT did not permit it. The tribunal disagreed, finding that it did have jurisdiction over the counterclaim, and potentially on claims by states against investors, as well. The fact that the BIT did not expressly permit counterclaims was not enough to sway the Tribunal, which held instead

⁶⁵ Articles 8.18 and 8.23 CETA

⁶⁶ Edward Guntrip, 'Urbaser v Argentina: The Origins of a Host State Human Rights Counterclaim in ICSID Arbitration?' EJIL: Talk! Blog available at <http://www.ejiltalk.org/urbaser-v-argentina-the-origins-of-a-host-state-human-rights-counterclaim-in-icsid-arbitration/> (accessed on 14 March 2016)

⁶⁷ Urbaser S.A. and Consorcio de Aguas Bilbao Bizkaia, Bilbao Biskaia Ur Partzuergoa v. The Argentine Republic, Award of 8 December 2016

that the disputing parties had consented to counterclaims. In fact, the Tribunal found that the BIT in question permitted either party to bring a claim, including the possibility of a counterclaim and applied conditions to the counterclaim that were relatively flexible.⁶⁸

Despite the fact that Argentina eventually lost the case on the merits, Urbaser shows that it is entirely possible for investment tribunals to adjudicate claims by states against investors--even in the absence of explicit language to that effect in an IIA. This was an innovative position, given the more restrictive stance taken by other tribunals.⁶⁹

Some recent IIAs allow third parties, under certain conditions, to submit *amicus curiae* ('friend of the court') briefs, explaining their position on a case that has been brought by an investor.⁷⁰ *Amicus* status provides an opportunity for parties to participate where they do not have full standing. However, "amicus was never meant as a substitute for the right of standing"⁷¹ and it fails to fully rebalance the unfairness. Where *amicus* status is granted, the rights afforded to the *amicus* party are limited.⁷² Generally, *amicus curiae* submissions are only allowed where the parties to the proceedings (that is, the investor and the state) do not object, where the *amicus* submission would assist the investment tribunal by bringing a different perspective or insight, and where the third party has a significant interest in the case.⁷³

The European Commission has recently proposed that in addition to submitting *amicus curiae* letters, third parties with a 'direct and present interest' in a case should be allowed to intervene in support of one of the parties to the proceedings.⁷⁴ ClientEarth welcomes this proposal as a step in the right direction of making ISDS fairer and more inclusive. However, inclusion of such procedural rights does not go nearly far enough -- and worse, has not been included in the text of recent trade agreements negotiated by the EU.⁷⁵

One related issue is, for instance, the possibility of out-of-court settlements without proper democratic scrutiny of such settlements. Almost a quarter of disputes are settled.⁷⁶ Those settlements might affect the rights and interests of third parties, for instance, if a mining permit is handed out as part of a settlement that will affect the environment and interests of local inhabitants. In fact, a recent study has found that settlements are more likely when the investor and the state

⁶⁸ *Ibid.*, paras. 1110-1134

⁶⁹ Edward Guntrip, 'Urbaser v Argentina: The Origins of a Host State Human Rights Counterclaim in ICSID Arbitration?' EJIL: Talk! Blog available at <http://www.ejiltalk.org/urbaser-v-argentina-the-origins-of-a-host-state-human-rights-counterclaim-in-icsid-arbitration/> (accessed on 14 March 2016) citing *Saluka Investments B.V. v. The Czech Republic*, UNCITRAL

⁷⁰ For instance, CPTPP, Article 9.23(3) permits the submission of *amicus curiae* brief "[a]fter consultation with the disputing parties...". Similarly, CETA enables the Tribunal to accept or invite submissions from non-disputing parties but only regarding the interpretation of CETA and only after consultation with the disputing parties (CETA, Article 8.38)

⁷¹ Gus Van Harten, Jane Kelsey and David Schneiderman, 'Phase 2 of the UNCITRAL ISDS Review: Why 'Other Matters' Really Matter' (2019) All Papers 328

⁷² *Ibid.*

⁷³ See, Art. 37 (2) ICSID Arbitration Rules. Similar rules apply under article 4 of the UNCITRAL Transparency Rules, with the notable improvement of giving the Tribunal more independence from the Parties to allow for *amicus* submissions

⁷⁴ Section 3 subsection 5 article 23 of the Commission's proposal for an Investment Court System in TTIP: "The Tribunal shall permit any natural or legal person which can establish a direct and present interest in the result of the dispute (the intervener) to intervene as a third party."

⁷⁵ Including CETA, the EU-Singapore FTA and the EU-Vietnam FTA

⁷⁶ Lise Johnson and Brooke Skartvedt Guven, 'The Settlement of Investment Disputes: A Discussion of Democratic Accountability and the Public Interest' Investment Treaty News, 13 March 2017 available at <https://www.iisd.org/itn/2017/03/13/the-settlement-of-investment-disputes-a-discussion-of-democratic-accountability-and-the-public-interest-lise-johnson-and-brooke-skartvedt-guven/> (accessed on 14 March 2017)

want to hide substantive or procedural outcomes from other affected persons.⁷⁷ Therefore, reforms should ensure that such settlements are fully accessible to the public and are subject to compliance with procedural and substantive requirements of domestic and international law.⁷⁸

The Rosia Montana case - *Gabriel Resources v Romania*⁷⁹

In 2015 Canadian mining company Gabriel Resources brought an ISDS claim against the Romanian government over government actions relating to the largest cyanide based open-pit gold mine project in Europe in Rosia Montana, Romania.⁸⁰ Despite a resolution of the European Parliament to ban cyanide based gold mining in Europe⁸¹, if approved, the mine project would increase the total use of cyanide in Europe over thirteen times. It would also result in the relocation of around 6000 local inhabitants, destruction of four mountains and its ecological infrastructure, and the destruction of UNESCO candidate world heritage site.⁸²

After nationwide protests and several court victories for local residents against both the government and Gabriel Resources, the Romanian government has not given permission for the project.⁸³

Local NGOs and residents do not have full participatory rights in the case. The only way for their voices to be heard is through submission of *amicus* briefs under the conditions set out in the Canada-Romania BIT. In November 2018, a group of Romanian and European NGOs filed an amicus brief.⁸⁴ The Tribunal however rejected legal arguments and limited the factual submission to issues that “do not refer or rely on testimonies”.⁸⁵

Although important and valuable, the submission of amicus briefs alone does not provide sufficient participation for affected parties to ensure that their rights and interests are properly accounted for in proceedings.

It is thus necessary and urgent to address this woefully inadequate system in a world in which transnational investors have enormous power to impact the environment, human rights, and labour rights.⁸⁶

⁷⁷ E. M. Hafner-Burton, S. Puig, and D.G. Victor, 'Against international settlement? The social cost of secrecy in international adjudication' (2017) Yale Journal of International Law, 45

⁷⁸ Lise Johnson and Brooke Skartvedt Guven, 'The Settlement of Investment Disputes: A Discussion of Democratic Accountability and the Public Interest' Investment Treaty News, 13 March 2017 op. cit.

⁷⁹ *Gabriel Resources Ltd. and Gabriel Resources (Jersey) v. Romania*, ICSID Case No. ARB/15/31

⁸⁰ Stephanie Danielle Roth and Jürgen Maier, 'Silence is Golden' (28 November 2016) available at <http://www.forumue.de/silence-is-golden/> (accessed on 15 March 2017)

⁸¹ European Parliament resolution of 5 May 2010 on a general ban on the use of cyanide mining technologies in the European Union

⁸² More information can be found at <https://www.rosiamontana.org/?language=en> (accessed on 15 March 2017)

⁸³ Ibid.

⁸⁴ ClientEarth, 'Local community voices to be heard in illegal Romanian gold mine litigation' (5 November 2018) available at <https://www.clientearth.org/local-community-voices-to-be-heard-in-illegal-romanian-gold-mine-litigation/> (accessed 6 March 2019)

⁸⁵ *Gabriel Resources Ltd. and Gabriel Resources (Jersey) v. Romania*, ICSID Case No. ARB/15/31, Procedural Order No. 19, 7 December 2018, paras. 60 and 66

⁸⁶ Ibrahim Kanalan, 'Horizontal Effect of Human Rights in the Era of Transnational Constellations: On the Accountability of Private Actors for Human Rights Violations' Enterprises' in Marc Bungenberg and others (eds), *European Yearbook of International Economic Law 2016* (Springer 2016), 423-460

ClientEarth understands that the Commission will not address the substantive obligations of either states or investors in its MIC proposal.⁸⁷ The MIC is intended to replace the current procedural and institutional provisions for ISDS that are set out in, for example, CETA Chapter 8, Section F. Similarly, the ongoing UNCITRAL ISDS talks are primarily concerned with procedural reform – although there is growing recognition that the scope of the deliberations should also address the substantive rights of investors.⁸⁸

In any event, the EU has even indicated openness in its MIC proposal regarding participation of affected third parties.⁸⁹ Even without extending the substantive obligations of corporations, or reducing those of states, ISDS reforms should contribute to making investment arbitration fairer and more inclusive. It would require to expand the scope of personal jurisdiction of the dispute settlement mechanism to allow it to hear claims by investors, states, and affected third parties, and to ensure that standing criteria are not unnecessarily constraining. It would also require public notice of claims and sufficient time for all affected parties to apply for standing. Moreover, it would have to allow a fair access to proceedings fully in line with and in the spirit of the Aarhus Convention.

Opening up the jurisdiction in this way would ensure that the dispute settlement mechanism could hear claims over breaches of investor obligations that may be contained in future IIAs. It would allow claims based on other international legal instruments containing obligations for transnational corporations. And it would permit third parties to intervene where their rights are affected by proceedings before the MIC.⁹⁰ This is a necessary part of making the system fairer and making it a forum that protects the rights of all people—not just those of corporations. It would therefore be a necessary step that would need to be accompanied with meaningful reform of the current international regime on investor rights and obligations.

4 Protection of responsible investment

Recommendation 4: limit the jurisdiction of the dispute settlement body to claims by responsible investors who comply with domestic constitutions and international standards of responsible investment, and exclude claims that target public interest legislation.

The MIC will be established by an international agreement and will be funded by public money. It will therefore be a public service provided to investors. As such, it is legitimate to ask, as a matter of public policy, what kind of investments countries that will ratify it want to protect through the MIC.

For developing countries in particular, promoting foreign investment is not an end in itself but a means to an end. The types of investments and their operating standards, not just their volume,

⁸⁷ ClientEarth supports the inclusion of substantive obligations for investors in IIAs, as well. This is not a novel idea: India's Model BIT, for example, includes a number of obligations that investors must respect when they make an investment in a host country. See articles 9-12 of the India Model Bilateral Investment Treaty available at https://www.mygov.in/sites/default/files/master_image/Model%20Text%20for%20the%20Indian%20Bilateral%20Investment%20Treaty.pdf (accessed on 14 March 2017). However, that is not the subject of this legal policy brief

⁸⁸ Gus Van Harten, Jane Kelsey and David Schneiderman, 'Phase 2 of the UNCITRAL ISDS Review: Why 'Other Matters' Really Matter (2019) All Papers 328

⁸⁹ EU Submission, op. cit., paras. 27, 29 and 37

⁹⁰ The UN Human Rights Council, for example, is currently negotiating a treaty that would impose binding human rights obligations on transnational corporations. See UN Human Rights Council Resolution 26/9, Elaboration of an international legally binding instrument on transnational corporations of and other business enterprises with respect to human rights 26 June 2104 A/HRC/26/L.22/Rev.1

therefore matter a great deal to the contribution that they can make for development purposes in states that need it.

In this light, governments should not set up an international court that would allow investors to bring claims that violate domestic rules or international standards of responsible investment, or target public interest legislation. It is therefore necessary to introduce a number of measures to provide an incentive for investors to act responsibly and ensure that they cannot use the MIC to pursue claims that violate national rules or international standards. The set of measures should include:

1. **a clean hands clause**, allowing only responsible investors to bring claims;
2. **a public interest carve out**, protecting public interest measures from challenge; and
3. **a supremacy clause**, clarifying that investment protection should not come at the expense of the human rights and environmental obligations as contained in constitutions and international agreements.

4.1 Clean hands clause

In order to ensure that investors do not use the dispute settlement mechanism to pursue claims that violate domestic and international rules, governments should include a ‘clean hands clause’ in the MIC proposal. This clause would aim to dismiss any claim regarding an investment that violates host state law. As a result, it ensures that only investors with ‘clean hands’ can bring a claim against the state. Those that have violated host state rules would not be able to take advantage of the special protections offered by this public service.

Including a clean hands clause would be relatively easy. CETA Article 8.1 already makes clear that covered investment that is inter alia “made in accordance with the applicable law at the time the investment is made”. Moreover, CETA Article 8.18(3) already includes a list of reasons for excluding investors from ISDS. This list could simply be expanded to cover situations in which investors have committed fraud, human rights abuses, or otherwise violated national or international environmental, social, consumer, or labor laws.

Example of a clean hands clause based on Articles 8.1 and 8.18 (3) CETA:

*“An investor may not submit a claim if the investment has been made through fraudulent misrepresentation, concealment, corruption, conduct amounting to an abuse of process, **fraud, human rights abuses, or not in accordance with the applicable environmental, social, and consumer law, including international law.**”*

4.2 Public interest carve-out

In addition to the clean hands clause, a public interest carve-out would exclude challenges to public interest legislation. This public interest carve-out would ensure that claims involving tobacco legislation, environmental permits, health care legislation, minimum wage legislation, or other public interest rules cannot be brought before a potential MIC.

A public interest carve-out is extremely important, because one of the most serious downsides to ISDS as it currently exists is that investors have used it to challenge national environmental, health, and human rights rules, or to pressure states not to adopt such rules under threat of litigation. For example, after Philip Morris used the Australia-Hong Kong BIT to attack Australia's plain packaging laws, Australia insisted that a 'tobacco carve-out' be included in the Comprehensive and Progressive Transpacific Partnership (CPTPP) agreement.⁹¹ Procedural safeguards are thus necessary to guarantee the parties' right to regulate in the public interest over the protection of the investor.

A public interest carve-out could be inspired by CPTPP's 'tobacco carve-out', expanded to include a broader set of public interest laws and policies.

Example of a public interest carve-out

"No claims can be brought before the Multilateral Investment Court challenging public interest measures contributing to or aiming at inter alia environmental, social, human rights, or consumer protection."

Such carve-out is particularly important for developing countries where their national legislation regarding social and environmental standards is continuously evolving. It is thus of paramount importance to ensure that public interest legislation in these fields cannot be subject to interpretation as breach of an investor's legitimate expectation.

CETA does currently contain a 'right to regulate' clause that states that 'the Parties reaffirm their right to regulate within their territories to achieve legitimate policy objectives, such as the protection of public health, safety, the environment or public morals, social or consumer protection or the promotion and protection of cultural diversity'.⁹² However, the right to regulate clause merely restates Parties' ability to regulate in the public interest. It does not exclude claims by investors based on such public interest legislation. In other words, under CETA a government may adopt public interest regulations, but will still be required to pay compensation to investors if those regulations infringe on their rights. A public interest carve-out would solve this problem by ensuring that investors could not challenge public interest regulations in the first place.

4.3 Supremacy clause

In addition to a clean hands clause and a public interest carve-out, governments should also consider the inclusion of a supremacy clause, clarifying that investment protections do not

⁹¹ Article 29.5 CPTPP states 'A Party may elect to deny the benefits of Section B of Chapter 9 (Investment) with respect to claims challenging a tobacco control measure of the Party. Such a claim shall not be submitted to arbitration under Section B of Chapter 9 (Investment) if a Party has made such an election. If a Party has not elected to deny benefits with respect to such claims by the time of the submission of such a claim to arbitration under Section B of Chapter 9 (Investment), a Party may elect to deny benefits during the proceedings. For greater certainty, if a Party elects to deny benefits with respect to such claims, any such claim shall be dismissed.'

⁹² Article 8.9 (1) CETA

outweigh the international social and environmental commitments. Sometimes, investors' rights come into conflict with obligations under states' own constitutions and international human rights, labour, or environmental agreements. In such cases, it is necessary to clarify which rules investment arbitrators should prefer. Unfortunately, in a number of ISDS cases, investment arbitrators have found that obligations under international environmental or human rights agreements cannot justify infringing on investors' rights.⁹³ This is an unacceptable outcome. Countries must have the policy space they require to fulfil their international social and environmental commitments. Including a supremacy clause would make clear to investment arbitrators that obligations arising out of the host state's constitutions or international environmental, social and human rights agreements trump obligations arising out of IIAs.⁷⁹ Such clause would be supported by the inclusion of a hierarchy of sources and in the event of a conflict between these rules, investor protections would give way to constitutional rules and public social and environmental obligations.

Inspiration for a supremacy clause can be taken from NAFTA article 104, which provides that in the event of any inconsistency between NAFTA and a list of environmental agreements, the obligations under the environmental agreements shall prevail.⁹⁴

Example of a supremacy clause

"In the event of any inconsistency between an international investment agreement and any international environmental, social, or human rights agreement binding on one Parties to a dispute, the obligations under the international environmental, social, or human rights agreement shall prevail."

In combination with the clean hands clause and the public interest carve-out, the supremacy clause would help to ensure that this special dispute settlement process, provided as a public service to investors, could be used only by responsible investors who respect international and host state law.

5 Independence of adjudicators

Recommendation 5: select and appoint members of the dispute settlement body in full accordance with the Magna Carta of Judges and through an accountable and transparent process.

Despite some improvements over the selection of tribunal members under CETA, concerns remain over the independence of adjudicators under the EU's current approach towards appointment of tribunal members.⁹⁵ Both the German and European Association of Judges have objected to the

⁹³ See Markus Krajewski, 'Ensuring the Primacy of Human Rights in Trade and Investment Policies: Model clauses for a UN Treaty on transnational corporations, other businesses and human rights' (Study commissioned by CIDSE) available at <http://www.cidse.org/publications/business-and-humanrights/business-and-human-rights-frameworks/ensuring-the-primacy-of-human-rights-in-trade-and-investment-policies.html> (accessed on 14 March 2017), at 13 referring to SAUR International SA v. Republic of Argentina, ICSID Case No. ARB/04/4, para. 331. See also B. Farrugia, 'The human right to water: defences to investment treaty violations', (2015) *Arbitration International* 31 (2), 261 at 265; Andreas Kulick, *Global Public Interest in International Investment Law* (Cambridge: Cambridge University Press, 2012) at 233-245 ⁷⁹ See Krajewski supra n 78

⁹⁴ Andreas Kulick, *Global Public Interest in International Investment Law* (Cambridge: Cambridge University Press, 2012) at 232-233

⁹⁵ Gus Van Harten, 'Key Flaws in the European Commission's Proposals for Foreign Investor Protection in TTIP', *Osgoode Legal Studies Research Paper No. 16/2016*, 3

Investment Court System (ICS) proposed under the TTIP negotiations, because the selection of tribunal members is not in line with the Magna Carta of Judges by the Consultative Council of European Judges.⁹⁶

The members of tribunals under the MIC should meet the requirements of judicial independence set out by the Magna Carta. Judicial independence should therefore be statutory, functional and financial. Moreover, the selection, nomination, and career of these tribunal members must be based on objective criteria and taken by a body in charge of guaranteeing independence.

With regard to the qualifications of tribunal members, it is of paramount importance that they demonstrate expertise in the area of public international law but also in areas such as consumer, environmental, human rights and labour law. Diversity of qualifications and experiences is crucial to ensure that the adjudicators will fully understand and properly assess the legal context in which the claim is brought before the court. Indeed, specialised knowledge in investment law alone is not sufficient to make a judgment whether an investor has been afforded with due process under the fair and equitable standard for example. An administrative or a constitutional law expert would be better placed to make such judgment.

This means that notably in contrast to the selection under ICS in CETA:

- There can be no financial incentive to hear claims;
- There should be no undue influence on these members, for instance by allowing tribunal members to work as arbitrators in investment cases on the side;
- The objective criteria for selection should include experience and knowledge of areas of law outside international investment law and international trade law;
- There should be clear and transparent rules regarding the selection process of the members and the appointment cannot be left to a committee such as the CETA Joint Committee.

Finally, it is essential to ensure that this new system will avoid duplicating the old system. Guarantees will have to ensure that tribunal members are not drawn from the narrow circle of investment lawyers, who have so far led the arbitration industry and are likely to be considered as the most qualified for the role.

6 Awards

Recommendation 6: Limit the amount of compensation available in order to cover only the value of proven economic damage resulting from the violation of the treaty and exclude the expected profits from the calculation of compensation

The question of compensation claimed by investors for damages resulting from the conduct of a government raises concerns for state public finances, especially in low-income countries struggling to finance their development needs.

⁹⁶ The text can be found here: <https://wcd.coe.int/ViewDoc.jsp?p=&id=1707925&direct=true> (accessed on 14 March 2017)

Investment treaties usually provide for compensation in line with the "fair market value" of the investment at the time the government took the measure, but the value of an investment may also include the investment performance in the future - the expected profits.

The calculation of the amounts due requires complex considerations and value judgments that involve balancing policy considerations against right to compensation. However, IIAs have been interpreted as allowing investments to dominate other competing considerations, thus compensating foreign investors in a number of situations where no compensation would be allowed under national law. Indeed, if compensation is a reparation for the damage caused, it is not always the appropriate remedy for the victim, nor the appropriate sanction against the perpetrator.⁹⁷

Given the threat of having to pay significant compensation, the authorities may be discouraged from acting for the sake of the public interest, the so-called "regulatory chill" effect.

It is therefore necessary to limit the amount of compensation to the value of the actual economic damage resulting from the infringement of the IIA and to exclude the expected profits.

Non-monetary remedies are also a source of concern. In a number of arbitration cases, investors sought a tribunal's order requiring the state to adopt a particular behavior - either as an interim measure in an often lengthy procedure or in relation to the final decision ("injunctive relief"). This increases the risk of regulatory chill. Some of these requests also interfered with the non-parties' remedies obtained against the investor, compounding concerns about the asymmetric nature of ISDS and its implications for the rights of third parties.⁹⁸

The substantive provisions of an investment treaty generally govern the standards of compensation for lawful expropriations, they do not specify how to calculate damages for breaches of the treaty. The procedural reforms could remedy this problem.

B. Alternative options

Some governments will arrive at the conclusion that ISDS is not necessary nor desirable. Others will find that the reforms options at UNCITRAL, such as the MIC, are insufficient or inadequate to address in a credible manner the unjustified risks associated with ISDS.

UNCITRAL members and observers should consider carefully another option for systemic reform that more fully addresses the flaws of the current system. A more viable policy option would be to terminate existing IIAs altogether and opt for readily available alternatives for protecting investment.

⁹⁷ Lise Johnson, Brooke Skartvedt Güven, and Jesse Coleman, 'Investor-State Dispute Settlement: What Are We Trying to Achieve? Does ISDS Get us There?' Columbia Center on Sustainable Development, December 11 2017 available at <http://ccsi.columbia.edu/2017/12/11/investor-state-dispute-settlement-what-are-we-trying-to-achieve-does-isds-get-us-there/>

⁹⁸ Lorenzo Cotula and Brooke Skartvedt Güven, 'Investor-state arbitration: an opportunity for real reform?' International Institute for Environment and Development, 7 December 2018, available at <https://www.ied.org/investor-state-arbitration-opportunity-for-real-reform>

Rather than piecemeal and inadequate reforms, withdrawal of consent to ISDS and/or termination of IIAs, could be the next step for reforming international investment law.⁹⁹ This would provide the opportunity for redesigning investor protections that better serve the world that exists today, not the world of the 1970s, and seek to achieve sustainable development goals.¹⁰⁰

ISDS is not the only option available for protecting investment. A number of alternatives could provide protection and ensure security for investments without the harms caused by outdated ISDS mechanisms. Some of these are explored below. These options are not necessarily mutually exclusive – more than one could be adopted in order to provide more fair, appropriate and effective investor protection.

1. Withdrawal of consent and termination of IIAs

Pending comprehensive and robust overhaul of the privileges afforded to investors through existing investment agreement (including ISDS mechanisms), states should demonstrate their commitment to re-balancing systems of investor protection to ensure fairness and impartiality. Through multilateral instruments, states could agree to (1) withdraw their consent to ISDS and / or (2) terminate existing investment agreements.¹⁰¹ These two options can be done unilaterally, but the UNCITRAL ongoing discussions represent an important opportunity for states to coordinate their approach.

By withdrawing consent to ISDS with immediate effect, states would stop ISDS mechanisms in their tracks – demonstrating firm commitment to a new order for resolving investment disputes. A multilateral instrument could help to provide legal and political support for this approach – making it more palatable for countries to adopt this approach.

As explored above, several states have already made unilateral commitments to terminate existing investment agreements. According to UNCTAD statistics 107 investment agreements containing ISDS have been terminated and not replaced in recent years. Last year more investment agreements were terminated than concluded.¹⁰²

A multilateral agreement through which many states jointly agree to withdraw their consent to ISDS and / or terminate existing agreements would provide a stronger position for states making this move. This could be modelled on the intra-EU BITs termination experience following the recent *Achmea* judgment. The EU approach is two-step. First, EU countries have agreed on a political declaration containing their commitment to terminate their intra-EU BITs and to undertake a set of actions.¹⁰³ This enabled setting up a common framework for the second step, a plurilateral instrument (termination treaty), to be ratified by all EU Member States before the 6th December

⁹⁹ Columbia Center on Sustainable Investment, 'Clearing the Path: Withdrawal of Consent and Termination as Next Steps for Reforming International Investment Law' (April 2018)

¹⁰⁰ See for instance the Declaration of Namur at <http://declarationdenamur.eu/en/> (accessed on 14 March 2017)

¹⁰¹ Columbia Center on Sustainable Investment, 'Clearing the Path: Withdrawal of Consent and Termination as Next Steps for Reforming International Investment Law' (April 2018)

¹⁰² UNCTAD IIA Issues Note, "Recent Developments in the International Investment Regime" (May 2018), available at <http://investmentpolicyhub.unctad.org/Publications/Details/1186>

¹⁰³ Declaration of the Member States of 15 January 2019 on the legal consequences of the *Achmea* judgment and on investment protection, https://ec.europa.eu/info/publications/190117-bilateral-investment-treaties_en

2019. The treaty will waive any notice periods or other conditions for termination and include a joint amendment of the underlying treaties to eliminate the sunset clauses in all BITs.

A less absolute but potentially valuable approach is a requirement that parties to a proposed arbitration must consent in writing to arbitration taking place before the arbitration has jurisdiction to adjudicate. The Indonesian government has proposed this in its submission to the UNCITRAL Working Group III Secretariat ahead of the April 2019 session.¹⁰⁴ This would ensure that parties have some information about the content and grounds for a claim before it can commence. It could also be used by states to limit which claims they will entertain. For instance, states could refuse consent to claims where local remedies have not (reasonably) been exhausted; where investors have failed to comply with their obligations to invest ethically; or where investors are attempting to challenge measures which benefit from a public interest carve-out of the type described above.

As the Indonesian government indicates “[t]his approach cannot be understood as a way for states to avoid international arbitration altogether”. Instead, it is a way for claims to be restricted to those which states agree ought to be heard by an arbitration panel.

2. Strengthening domestic judiciary

In many cases, domestic legal systems are the most appropriate and effective route for the resolution of investment disputes. Given this, trade and investment agreements should be used to restore, strengthen and maintain them. Agreements could include requirements that parties commit resources to help states develop their administrative, legislative and judicial capacities to ensure that domestic court systems can offer all parties fair and unbiased access to justice; hear disputes in accordance with the ‘rule of law’ – meaning that the law is applied consistently, predictably and not retroactively; and support transparency. Well-supported domestic systems must be able to fairly balance private and public interests and avoid bias.

Requirements to exhaust local remedies before resorting to supranational dispute resolution mechanisms, such as ISDS or state-to-state dispute settlement, will help to promote domestic legal systems. ELR rules draw attention to states’ courts. They encourage investors to consider the legitimacy and fairness of local systems. Requiring cases to be heard in local courts will help to build their capacity and experience through exposure to new questions and different, varied and well-resourced claimants.

3. Political risk insurance

Political risk insurance is an obvious market-based solution for investors to guard against investment risks. Where an investor is concerned about the legitimacy and independence of a domestic court system, it should purchase risk insurance to underwrite any costs such as through the Multilateral Investment Guarantee Agency of the World Bank.¹⁰⁵ This insurance can protect against costs incurred as a result of, amongst other things, political changes; legal uncertainty and expropriation within the host state. The risks covered by such insurance policies can actually exceed investment protection provisions such as ISDS.

¹⁰⁴ UN General Assembly, ‘Possible reform of ISDS: Comments by the Government of Indonesia’ (9 November 2018)

¹⁰⁵ The website of the Multilateral Investment Guarantee Agency can be found at <https://www.miga.org/>

In addition, insurance contracts can place obligations and conditions on investors to carry out their investment activities ethically and in the interests of the people and environment of the relevant state. For instance, investments insured by the US Government development financial institution, Overseas Private Investment Corporation (OPIC), must meet detailed environmental standards.¹⁰⁶

There are also advantages to this approach for investors. For instances, speed: compensation under an insurance policy is generally paid out much more promptly than the time it would take for a dispute to be resolved or settled under ISDS.

4. Dispute prevention

Some new generation investment agreements aim to avoid disputes by establishing collaborative mechanisms for consideration of any issues which may arise as between state parties. In both CETA and CPTPP, parties are required to conduct consultations for 6 months before formal recourse to ISDS is permitted.¹⁰⁷ Under India's model BIT, following the exhaustion of local remedies, parties must spend "no less than six months" using their best efforts to try to resolve the dispute amicably through meaningful consultation, negotiation or other third party procedures.¹⁰⁸ Similarly, Indonesia has introduced mandatory mediation in negotiations for its bilateral investment agreements. The Indonesian government hopes that this will "raise the profile of alternative dispute resolution process as an effective alternative..."¹⁰⁹

Brazil has gone further in attempting to avoid disputes in its recent Co-operation and Investment Facilitation Agreements (CIFAs). Its CIFA with Malawi, for instance, does not contain ISDS procedures. Instead, it requires the establishment of a Joint Committee which can consider "questions of specific interest to an investor" submitted to it by a party to the agreement.¹¹⁰ This state-led approach puts control firmly in the hands of the parties. The Joint Committee is tasked with, amongst other things, resolving any disputes in an amicable manner. The investor is able to participate in Joint Committee sessions. The fairness of the process is enhanced through the ability of third parties including government agencies and NGOs to also participate in Joint Committee meetings.¹¹¹ State-to-state dispute settlement can only be used if the dispute is not resolved by the Joint Committee.¹¹² This thrust of the collaborative approach is aimed at promoting a positive agenda to attract investment and dispute prevention instead of settlement.

5. State-to-state dispute settlement

State-to-state dispute settlement mechanisms avoid the entrenched asymmetry of ISDS by permitting claims from either state rather than just investors. They might provide a feasible and fairer alternative to ISDS. In addition, states are less likely than investors to challenge regulations made in the public-interest.

¹⁰⁶ OPIC, 'Environment and Social Policy Statement' (January 2017). Available at: [https://www.opic.gov/sites/default/files/files/final%20revised%20ESPS%2001132017\(1\).pdf](https://www.opic.gov/sites/default/files/files/final%20revised%20ESPS%2001132017(1).pdf)

¹⁰⁷ CETA, Article 8.22 and CPTPP, Article 9.19

¹⁰⁸ India model BIT (2016), Article 15.4

¹⁰⁹ UN General Assembly, 'Possible reform of ISDS: Comments by the Government of Indonesia' (9 November 2018)

¹¹⁰ Brazil-Malawi CIFA, Article 13.3

¹¹¹ Brazil-Malawi CIFA, Article 13.3(c)

¹¹² Brazil-Malawi CIFA, Article 13.6 states that "If the dispute cannot be resolved, the Parties to the exclusion of the investors may resort to arbitration mechanisms between States, which are to be agreed upon by the Joint Committee, whenever the Parties find it appropriate"

State-to-state procedures generally cover ‘disputes as to the interpretation or application’ of the relevant treaty. They allow home states to bring diplomatic protection claims on behalf of their investors. Where it is not expressly carved out, diplomatic protection cases must be brought in accordance with customary international law meaning that local remedies must initially be exhausted.

It is important to recognise that state-to-state procedures are not a panacea. Many of the procedural problems associated with ISDS are also relevant to state-to-state. For instance, state-to-state arbitrations are established on an ad-hoc basis, with for-profit arbitrators appointed by the parties. There is often insufficient transparency, unsatisfactory provision for third-party participation and decision-making can be inconsistent, incoherent and unpredictable. However, if these issues can be remedied, state-to-state dispute settlement could serve as a workable alternative to ISDS.

Conclusion

ISDS is a hugely flawed system in drastic need of re-evaluation. In that sense, the European Commission policy towards reform is to be welcomed. However, such a reform cannot be mere window dressing with a few cosmetic changes. Such a reform would risk vastly expanding and legitimising a system which is currently uneven, one-sided, and completely oblivious to the importance of domestic courts.

Given the lengthy reform process and the inadequacy of the currently proposed reform options, ClientEarth recommends that governments carefully consider the options of multilateral termination and withdrawal of consent from ISDS.

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