https://doi.org/10.5817/CZ.MUNI.P210-9497-2019-17

Investment Arbitration at the Crossroads of Public and Private International. Current Issues with ISDS[1]

Zoltán Víg, Gábor Hajdu***

Abstract

After decades of success, investment arbitration has become an extremely controversial topic, riven by multiple allegations and concerns among the experts and various interest groups. In this contribution, we aim to examine the most relevant and severe of these issues, including regulatory chill. Regulatory chill is a purported phenomenon that claims that investment arbitration favors foreign investors, and thus intimidates host states into refusing to implement policies that would contradict with the interests of foreign investors. We not only examine these problems, but also attempt to suggest some potential remedies for alleviating these issues.

Keywords

ISDS; Regulatory Chill; Chilling Effect; Investment Arbitration.

1 Introduction

The question of investment arbitration has been a long-standing issue in the field of international economic relations. The second half of the 20th century reinforced that this method of conflict resolution, typically called Investor-State Dispute Settlement ("ISDS"), would be the dominant and defining way of solving disputes between foreign investors and host states.

* University of Szeged, Faculty of Law and Political Sciences, Department of Private International Law, Tisza L. Krt. 54, Szeged, Hungary, vigz@juris.u-szeged.hu

** University of Szeged, Faculty of Law and Political Sciences, Department of Private International Law, Tisza L. Krt. 54, Szeged, Hungary, gaborhajdu888@gmail.com

1 This research was supported by the project nr. EFOP-3.6.2-16-2017-00007, titled *Aspects on the development of intelligent, sustainable and inclusive society: social, technological, innovation networks in employment and digital economy*. The project has been supported by the European Union, co-financed by the European Social Fund and the budget of Hungary.

Due to its perceived advantages of objectivity and being unbound by host state interests, these arbitration tribunals became extremely popular and ISDS itself became a characteristic element of not only bilateral investment treaties ("BITs"), but also of free trade agreements' ("FTAs") investment chapters.

Yet, as time went on and more cases appeared, the publicity surrounding the concept also grew. And with it, came criticism. The first critics appeared in professional and academic circles, but in the last decade, the issue has also spread to the wider public. Investment arbitration was attacked for its seeming lack of transparency and accountability. It became evident that there is a clear divide between environmental and other public interest policy objectives and corporate-backed business interests. This opposition has shaped the debate surrounding investment arbitration ever since, and led to the articulation of several different problems that potentially could stem from ISDS.

Chief among the issues raised against ISDS-style investment arbitration is the supposed problem of regulatory chill. In short, proponents of this phenomenon claim that as a result of several dissuading factors, such as perceived pro-investor bias of the arbitrators or disproportionately large awards, host countries start to fear opposing the interests of foreign investors, and this in turn leads to lack of legislation (regulation), even when it would be necessitated and justified by public policy objectives. As noted beforehand, this is particularly problematic in case of pro-environmental legislation, which is particularly fragile and prone to being opposed to business interests. Of course, it cannot be denied that there could be several other influencing factors when it comes to regulatory chill, and it would be unwise to exclusively attribute the supposed phenomenon to the outcome of few ISDS cases.

Henceforth, this article seeks to discuss the nature and characteristics of this phenomenon. First, it will examine the historical aspects that led to the current situation. Following that, ISDS-related issues will be discussed, and then regulatory chill as a concept will be scrutinized. Based on these observations, the article will attempt to find a suitable answer to the question of how ISDS could be improved in the conclusion.

2 Historical development of ISDS and foreign investment protection in general

Before discussing ISDS-related issues, we examine the historical background of foreign investment protection in general and ISDS itself. To begin with, ISDS' history is not particularly long. The question of foreign investment first arose in the 19th century. This was the time when world trade truly became significant, and trans-country investments really took off. However, at this time, legal instruments for the protection of the property of foreign investors were still rather underdeveloped, and no solution existed that was pleasing to both the foreign investor and the host country. For the former, trusting in the local courts to resolve disputes was a foolhardy affair, and thus most foreign investors instead sought the diplomatic (and occasionally military) assistance of their home countries. By turn, this solution was naturally displeasing to the host country, which could find itself subject to diplomatic pressure or even outright military intervention. A good example of this was the 1861 French military expedition to Mexico, which was partially borne out of a desire to effectuate certain claims from French investors and creditors against the Mexican state.[2]

A real change came after the Second World War, when newly decolonized countries slowly realized that they needed foreign investments to develop their own economies, their attempts at economic independence slowly petering out. But while individual developing countries might have been open to negotiations, the general international atmosphere in already established milieus was still not very conductive to the matter. As a result, a solution was found in BITs, which first appeared in the late 1950s. These treaties were concluded between a developed country and a developing country, and contained a number of safeguards and measures aimed at ensuring the security of foreign investments, thus stimulating economic growth.[3] Most importantly, these treaties contained a novel dispute resolution method, which came to be called ISDS. This entailed neutral arbitrators being responsible

2 Torbágyi P. *Magyar Kivándorlás Latin-Amerikába az Első Világháború Előtt*. Szeged, 2009, p. 41.

3 Bilateral Investment Treaties 1959–1999 [online]. *UNCTAD*. Published in 2000, p. 1 [cit. 3. 9. 2019]. https://unctad.org/en/Docs/poiteiiad2.en.pdf

for hearing legal claims of foreign investors and adjudicating over them.[4] As we will see, this proved a popular solution, as it dealt with the local courts debate in a systematic and regulated manner.

As the 20th century rolled on, BITs and ISDS were becoming increasingly popular. This popularity eventually brought with it the need for a more formalized and systemic approach to ISDS procedures. This came to the fore in the 1960s. In 1965, the International Bank for Reconstruction and Development (IBRD) approved the submission of a convention to its members, the Convention on the Settlement of Investment Disputes. This convention outlined several general rules for ISDS, and also called for the establishment of an International Centre for Settlement of Investment Disputes ("ICSID") that would facilitate the administration of these procedural rules and provide general support to investment disputes, such as lists of arbitrators or maintaining case databases. By 1966, the Convention was signed, ratified and came into effect. In the decades since, ICSID has become the dominant facilitator of ISDS-related processes.[5] Thus we can state that while the anti-exploitation movements were still ongoing, there were already measures being put into place, and ISDS was already growing in popularity as a method of investment dispute resolution.

The success of the BITs can also be seen from the number of treaties that were concluded. From 1959 to 1969, there were yet only seventy-five BITs. From 1970 to 1979, countries concluded ninety-two BITs. The first sign of rapid growth was to be seen in the ensuing decade, as the number of BITs concluded in 1980s rose to 219.[6] This can be easily explained when we consider the general geopolitical climate of the time. By the 1980s, NIEO[7] and its supporters petered out, while the USSR-led socialist bloc was suffering from a severe downturn in influence, while China was slowly opening up to foreign investment themselves. These numbers alone show us that attitudes towards foreign investments were growing more hospitable

4 Lester, S. The ISDS controversy: How we got here and where next [online]. *ICTSD.* Published in 2016 [cit. 3. 9. 2019]. http://www.ictsd.org/opinion/the-isds-controversy-how-we-got-here-and-where-next

5 Parra, A. R. *The History of ICSID.* Oxford: Oxford University Press, 2012, pp. 1–2, 8.

6 Vandevelde, K. J. A Brief History of International Investment Agreements. *U.C.-Davis Journal of International Law & Policy*. 2005, Vol. 12, No. 2, p. 172.

7 New International Economic Order.

even in developing countries (or alternatively, we could theorize that they were forced into these agreements by economic necessity).

The true explosion, however, happened in the 1990s. During this decade, 1472 BITs were concluded.[8] This truly phenomenal expansion can be easily explained once more, if we consider that the above-mentioned processes during the 1980s only continued to intensify during the 1990s, and we can also add the true demise of the USSR and the Eastern Bloc as obvious reasons for the great increase in BITs. And to conclude the historic perspectives, we have to mention a recent trend in which BIT-like clauses are slowly being included in a number of FTAs such as NAFTA or CETA (in its original form), though the current legal situation of some of these FTAs is still uncertain. This shows to us that regulating the protection of foreign investments through international agreements has remained a staunch phenomenon, thus ensuring that ISDS too is relevant and discussable in contemporary times.

3 Issues related to ISDS

Despite its great popularity as a core component of countless BITs, and its place as the primary method of solving investment-related disputes, ISDS is increasingly facing numerous critiques, which we will examine now. However, we will reserve a separate section for the greatest potential issue, regulatory chill.

First of all, we have to address the reasons for the rise of ISDS system's criticism. One element is that foreign investment protection and investment arbitration of this specific type were without real historical precedent, meaning that when they were conceptualized, then implemented into the first BITs, it was difficult to judge accurately how it would all work in practice. Furthermore, there were relatively few cases of investment arbitration at the beginning, and these disputes were rarely reported to the public, meaning that they usually escaped any sort of public awareness or scrutiny. However, by the 1990s, the practical consequences of the ISDS and its related

8 Bilateral Investment Treaties 1959–1999 [online]. *UNCTAD*. Published in 2000, p. 1 [cit. 3. 9. 2019]. https://unctad.org/en/Docs/poiteiiad2.en.pdf

substantive investment protection regime had become increasingly clear, and with the number of cases growing, it was inevitable that some cases would be publicly reported and thus examined by the general audience.[9] So it was that with greater scrutiny came a more widespread recognition of issues with the system.

When it comes to listing the issues raised by ISDS and the general investment protection regime that it accompanies, procedural issues seems like an appropriate starting point. The most obvious of these is the fact that ISDS is a one-sided dispute settlement method. The foreign investment protection treaties that can serve as the legal basis for claims typically only contain substantive provisions related to foreign investments and investors, meaning that only they have the legal bases to initiate disputes and present claims. And while documents like the ICSID Convention or the UNCITRAL Arbitration Rules allow in principle counterclaims from respondent host states, the same is often not true of investment treaties (e.g. ECT) both from a procedural and substantive perspective, and in practice, the host state is rarely allowed by the arbitration tribunal to bring any substantial counterclaims into the dispute (meaning that they can only ask for the case to be dismissed and cannot realistically present their own grievances against the foreign investor except as a counter-argument to the investor's claims).[10] There might be historical reasons for this. The primary function of ISDS-style investment arbitration was to provide a supposedly objective form of dispute resolution for the foreign investor's benefit. Thus, it was natural that the system did not significantly account for claims by host states. We can easily assume that the view was that the host state had already enough ways (typically regulation in the name of public interest) to find remedies for any perceived grievance, in sharp contrast to the foreign investor, who is a private actor with theoretically more limited options. Nevertheless, this issue had seeped into the current trend of ISDS-opposition, as it is an obviously asymmetrical element of the system.

9 Lester, S. The ISDS controversy: How we got here and where next [online]. *ICTSD*. Published in 2016 [cit. 3. 9. 2019]. http://www.ictsd.org/opinion/the-isds-controversy-how-we-got-here-and-where-next

10 Reform Options for ISDS [online]. *UNCITRAL*, p. 4 [cit. 5. 9. 2019]. https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/uncitral_recs_and_justification_final.pdf

Next up is the fact that not only the respondent host state's options are limited, this system of dispute resolution is also constrained on the plaintiff's end. The meaning of this is that investment arbitration is an exclusive process reserved only for foreign investors and no others, thus it is a highly privileged remedy. This means that the domestic investors of the host state are in a natural disadvantage compared to foreign investors, since they lack one of the potential tools to remedy any grievances, they have suffered from the host state's actions.[11] This is once again theoretically justified when we look at the historical origins of ISDS. The drafters of the ISDS system likely assumed that since domestic investors already have theoretically fair, or even a more advantageous position in domestic legal recourses, there is no actual need for them to be included in a mechanism designed to protect foreign investors' investments. However, this interpretation raises the question of whether we can truly speak about equality before the law, if one investor receives a special and substantial privilege that others do not, on account of their nationality? This perceived unfairness has likely added further fuel to the criticism surrounding ISDS.

Another related aspect that should be mentioned is that many BITs do not require foreign investors to exhaust local remedies before they can turn to ISDS-style investment arbitration. This presents a further advantage for foreign investors, and essentially allows them to bypass the host state's internal judicial system completely.[12] The reasoning for this can also be found in the historic origins and evolution of ISDS. It stands to reason that foreign investors would not trust host state's courts to be unbiased, and to provide prompt decisions and compensation. In fact, it is quite easy to theorize that domestic courts could potentially frustrate the foreign investors by significantly prolonging their own processes. Given the length of investment arbitration as it is, this would logically lead to the foreign investors being denied of their awards for an unreasonable amount of time. Naturally, while this explanation seems like a probable theory, it does not diminish the fact that

11 Mohamadieh, K. The Future of Investor-State Dispute Settlement Deliberated at UNCITRAL: Unveiling a Dichotomy between Reforming and Consolidating the Current Regime. *Investment Policy Brief*. 2019, No. 16, p. 2.

12 Ibid., p. 6.

this element of ISDS can easily be turned into an argument about depriving host states of their sovereign rights.

To continue, another investor-related issue is the frequent lack of a clean hands clause. This means that arbitration tribunals and panels do not assess whether the foreign investor violated the host state's domestic laws and regulations when it comes to determining whether the foreign investor has access to the ISDS system for the given claim. A strong example of this can be found in the *Copper Mesa Mining Co. v. Republic of Ecuador* case, where the arbitration tribunal refused to consider Ecuador's objections about how the foreign investor in question used unlawful and violent means to pursue their agenda within the host state, up to hiring armed men for violent purposes. Not only the tribunal did not find this an impediment to the submission of the foreign investor's claim, it actually ended up favoring the foreign investor in its final award.[13] The same argument also arose in relation to the *Yukos Universal v. Russia*, but was presented to a Dutch court of appeals. The court, unlike the ISDS tribunal in the previous case, acknowledged the unclean hands argument.[14] In general, we can once again state a historical explanation for the lack of these clauses in investment treaties. It stands to reason that with the general mistrust in domestic legal processes, there might also have been a mistrust in domestic legislation. Thus, it made some sense not to include such clauses, since it could potentially lead to abuse by the host state to deny the ISDS system to foreign investors, or would otherwise require the tribunal to assess the objectivity or fairness of domestic regulation well before the merits phase. Furthermore, this would raise further questions about what tribunals would base their assessments on. Therefore, while this criticism seems legitimate on the surface (especially with the extreme example being provided), practical implementation of such clauses might not be the ideal approach.

13 Reform Options for ISDS [online]. *UNCITRAL*, p. 7 [cit. 5. 9. 2019]. https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/uncitral_recs_and_justification_final.pdf

14 De Korte, J., Wilts, G. Court allows Russia's unclean hands argument against former Yukos shareholders (Court of Appeal in The Hague) [online]. *Vosdk.nl*. Published on 3 October 2018, 4 p. [cit. 5. 9. 2019]. https://www.vosdk.nl/assets/files/assets/uploads/Court_allows_Russias_unclean_hands_argument_against_former_Yukos_shareholders___1.pdf

Besides the particularities of initiating an ISDS process, there is also the matter of arbitrator selections. Two issues are frequently raised in relation to this aspect. The first is the claim that arbitrators lack impartiality and independence. This is based on the logic that since only foreign investors can initiate arbitrations, and investment arbitrators operate on a for-profit basis, there would naturally be a pro-investor bias in arbitrations (since arbitrators benefit from foreign investors making continued use of ISDS).[15] This interpretation, in our opinion, misses the fact that respondent host states also have an influence on the selection process, and that obviously biased arbitrators would not be accepted by the host state. Furthermore, if we look at the statistics of known investment arbitration cases, there is no discernible advantage given to foreign investors when it comes to the outcome of the cases. For example, in the UNCTAD's database, there are 215 cases where the tribunal decided in favor of the host state, and only 173 cases that were decided in favor of the foreign investor.[16] Thus, the lack of obvious clues to this bias implies that it is not a decisive factor, in our opinion.

The secondary argument against arbitrator selection is that in practice, investment arbitrators come from a small pool of candidates, which raises the possibility of an overtly close intellectual consanguinity (a sort of elite and exclusive arbitrator clique), which in turn could lead to limited perspectives and decisions divorced from practical realities. However, this argument is very easy to dismiss if it is considered that the parties are ultimately responsible for choosing arbitrators, and that the most often picked arbitrators are often considered the best professionals in their field by the surveyed parties.[17] Thus, we can conclude that this factor also does not hold much weight, but nevertheless, it likely contributed to ISDS' image as an elitist institution in the public's eye.

15 European Federation for Investment Law and Arbitration A response to the criticism against ISDS [online]. *EFILA*. Published in 2015, pp. 17–18 [cit. 5. 9. 2019]. https://efila.org/wp-content/uploads/2015/05/EFILA_in_response_to_the-criticism_of_ISDS_final_draft.pdf

16 Investment Policy Hub [online]. *UNCTAD* [cit. 3. 9. 2019]. https://investmentpolicy.unctad.org/investment-dispute-settlement

17 European Federation for Investment Law and Arbitration A response to the criticism against ISDS [online]. *EFILA*. Published in 2015, pp. 21–22 [cit. 5. 9. 2019]. https://efila.org/wp-content/uploads/2015/05/EFILA_in_response_to_the-criticism_of_ISDS_final_draft.pdf

Another raised issue in connection to arbitrators is that whether investment arbitrators delegate their duties to arbitral secretaries in an unethical and improper manner. This criticism was given significant boost by the *Yukos Universal v. Russia* case, where Russia argued (and submitted a forensic linguist's report) that a large portion of the final award, including a significant percentage of the case's substantive analysis, was written by an arbitral secretary. While this ultimately remained unconfirmed, it did cast an unfortunate shadow on the issue.[18] Furthermore, we also have to note that ethical and other rules on arbitral secretaries can be rather vague. For example, the Young ICCA[19] Guide on Arbitral Secretaries 2014 notes that arbitral secretaries can have roles beyond purely administrative ones, as dictated and overseen by the arbitral tribunal. These can include drafting tasks for example.[20] This means in general that the role of arbitral secretaries in a given case is mostly uncertain.

Now that we are examining the conduct of arbitrators during the process, we turn to another commonly raised issue, the lack of transparency. In its original form, ISDS left little to transparency, and documentation such as hearings, awards, third-party participation and other related materials were often not available. However, it should be noted that in recent years, there has been a great increase in transparency, and investment arbitration is now far more accessible than ever before, and surpasses the transparency of domestic dispute resolution in several countries.[21] Of course, we can't discount that in domestic cases, hearings are open and public unless specifically asked by the parties, while the opposite is true in arbitral cases. In our opinion, it is undeniable that investment arbitration-related materials are now quite accessible and researchable, with cases that are not being the exceptions rather than the rule. Nevertheless, it is quite obvious that this

18 Nolan, M. D. Challenges to the Credibility of the Investor-State Arbitration System. *American University Business Law Review*. 2016, Vol. 5, No. 3, p. 442.

19 International Council for Commercial Arbitration.

20 Galagan, D., Zivkovic, P. The Challenge of the Yukos Award: an Award Written by Someone Else – a Violation of the Tribunal's Mandate [online]. *Kluwer Arbitration Blog*. Published in 2015 [cit. 8. 9. 2019]. http://arbitrationblog.kluwerarbitration.com/2015/02/27/the-challenge-of-the-yukos-award-an-award-written-by-someone-else-a-violation-of-the-tribunals-mandate/

21 IBA Arbitration Subcommittee. *Consistency, efficiency and transparency in investment treaty arbitration*. 2018, p. 53.

proactive response to transparency issues ultimately spurred other forms of criticism. As we noted in the historical section, criticism of ISDS did not really become particularly loud before the 2000s. While it's true that this was mainly the result of several high-profile cases, greater public (and thus media) access to ISDS cases in general likely contributed to the increase in ISDS critiques.

There is a further problem that is indirectly related to transparency, the lack of substantial third-party access to investment arbitration proceedings affecting them. Investment arbitration often has effects on other entities besides the respondent host state itself, such as local communities, businesses and organizations. However, the ability of these entities to participate in disputes is quite limited. *Amicus curiae* is an option, but third parties have little power besides submitting briefs. They typically have limited access to evidence, cannot participate in oral debates and cannot receive compensation, for example.[22] As noted, investment arbitration can have severe repercussions for individual parties that do not directly participate in the proceedings, and in turn, their method of participation when allowed at all, is often ignored or highly limited. The counter-argument would be that the respondent host state can adequately represent the interests of these affected, but while this may be true in principle, it is questionable just how much it can be applied when considering practical realities and that host states may not be intimately aware of or tied to these affected entities.

To continue, we also have to mention that the duration and associated legal and other costs of investment arbitration are often considered problematic. An ISDS process is resource-intensive for both parties, and given that many cases tend to linger for long, costs can also rise to levels that have negative impacts on the parties involved. It is sometimes even suggested that for developing countries (who are particularly vulnerable to financial issues), the inclusion of ISDS provisions into their BITs could easily end up causing a negative impact on their finances, even if they do not lose cases, merely because of the high costs of the proceedings. And given that these are

22 Reform Options for ISDS [online]. *UNCITRAL*, pp. 9–10 [cit. 5. 9. 2019]. https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/uncitral_recs_and_justification_final.pdf

developing countries, funds used for acting as respondents in ISDS cases would likely be needed elsewhere, often for urgent developmental needs. This can end up causing a disproportionally heavy burden for them when it comes to participating in cases.[23] In our opinion, we have to consider that while this is a severe issue, instituting a "loser pays everything" scheme would be equally unwise. Foreign investors (who have typically just missed out on significant sums given that they are participating in an ISDS case as the plaintiff) can equally struggle with appropriately financing their participation, and we can easily theorize that deflecting all costs onto them in a failed claim would reduce their practical ability to utilize the ISDS arbitration. This is compounded by the next issue detailed below, which makes ISDS tribunals difficult to predict in their rulings.

Finally, we would also need to discuss the conduct of arbitrators when it comes to interpreting the provisions of a given investment protection treaty. First of all, it has to be noted that there are no uniform standards or any set precedent. Arbitral practice may refer to earlier ISDS cases when making their own conclusions, but it may just as freely ignore it. A good example of this is that fair and equitable treatment standard is often interpreted in many different ways by arbitral tribunals, and there is a lack of a universal method of valuation for awarding damages.[24] Compounded by the *ad hoc* nature of investment arbitration, the lack of any permanent courts and so on, we believe that it becomes questionable whether any consistent practice can be set under such circumstances.

In conclusion, we can state that while ISDS suffers from several critiques, many of these have been resolved or are in the process of being resolved, while solutions for others do not appear so obvious. In the next section, we discuss the arguably greatest criticism of ISDS, the so-called "chilling effect".

---

23 Report of Working Group III (Investor-State Dispute Settlement Reform) [online]. *United Nations Commission on International Trade Law*. Published in 2018, pp. 7–8 [cit. 11. 9. 2019]. https://undocs.org/en/A/CN.9/930/Rev.1

24 Touzet, J, de Vaublanc, M. V. The Investor-State Dispute Settlement System: The Road To Overcoming Criticism [online]. *Kluwer Arbitration Blog*. Published on 6 August 2018 [cit. 12. 9. 2019]. http://arbitrationblog.kluwerarbitration.com/2018/08/06/the-investor-state-dispute-settlement-system-the-road-to-overcoming-criticism/

4 Regulatory Chill

Now that we have looked at the various issues surrounding ISDS, it is time to talk about one of the most ambiguous and multifaceted problems of them all. That critique is regulatory chill, or the chilling effect. Despite its elusive nature, and that it is somewhat hard to pin down or objectively prove, regulatory chill has captured the imagination of many critics of investment arbitration, and we shall now examine why this is so.

The first step is determining the exact nature of regulatory chill. According to one perspective, we can speak about two general interpretations of the term: broad and narrow. In broad terms, regulatory chill can be interpreted as the general chilling (freezing) of all legislation and regulation that could affect foreign investors, with legislators and policy-makers considering the potential effects of their new regulations on foreign investors as early as during the drafting process. As a consequence, this chilling effect thus stunts any drastic legislative measure that has the potential of affecting foreign investors. Meanwhile, a narrow interpretation of regulatory chill focuses on the situation when a specific measure is apparently chilled or stopped, after the legislators had been made aware of the threat of foreign investors utilizing ISDS to sue for damages if the measure in question goes into effect or otherwise remains.[25] In a later work, *Tienhaara* also proposes the existence of a third type of regulatory chill, cross-border chill. In her view, this type of regulatory chill can exist when a government pursues some sort of measure and policy that affects foreign investments on a wide scale, and is easily transferable to other jurisdictions, which are then likely to emulate such a measure. In this case, the foreign investor's intent is not necessarily to chill the regulation in the jurisdiction it is targeting through ISDS, but to forestall and prevent such measures from being adopted in other jurisdictions where the foreign investor is active in the affected fields. In this view, not even the outcome of the ISDS case itself is necessarily indicative of whether

25 Tienhaara, K. Regulatory chill and the threat of arbitration: a view from political science. In: Brown, C., Miles, K. (eds.). *Evolution in Investment Treaty Law and Arbitration*. Cambridge: Cambridge University Press, 2011, p. 2.

the foreign investor's chilling aims have been achieved or not.[26] In our view, the first interpretation is nearly impossible to ascertain (thus, lending weight to the argument that regulatory chill is far too vague of a phenomenon), while even the narrow interpretation can be difficult to prove, unless the researcher has enough insight into the policies and process of legislation in question. However, it is true that such narrower definitions of regulatory chill could be tested through examining the actual output and behavior of legislators once regulatory chill hypothetically arises. As for the third possible interpretation of regulatory chill, it is necessary to ascertain what is specifically the easily transferable legislation in question, whether it can be determined with reasonable certainty that other jurisdictions were going to adopt the measures (and which jurisdictions), and whether it can be said that the ISDS case served as the primary reason for why they haven't. In our view, this interpretation also implies that foreign investors are consciously attempting to use regulatory chill as an intimidation tool against numerous host states, and the chilling effect is not simply a result of their behavior.

There are also other possible forms of categorization when it comes to regulatory chill. In one such case, we can speak about three types of chilling effect: anticipatory chill, response chill and precedential chill. Anticipatory chill is similar to the broad interpretation of regulatory chill, if not quite as advanced. In this scenario, the policy-maker simply weighs whether the given measure or legislation could lead to being challenged through ISDS. However, this does not quite carry the same extent of chill-internalization as the broad interpretation above. Meanwhile, response chill applies to cases where the policy-maker becomes aware of the risk of ISDS in relation to a specific measure and thus makes steps to rectify this. An example of this potentially happened in *Vattenfall v. Germany (I.)*, where after receiving the notice of arbitration, the government of Hamburg had already started modifying the disputed regulations. Thus, we can say that response chill is nearly, if not exactly the same as the narrow interpretation of regulatory chill. And finally, precedential chill refers to situations when an already concluded ISDS case influences the policy-maker, regardless of whether it has

26 Tienhaara, K. Regulatory Chill in a Warming World: The Threat to Climate Policy Posed by Investor-State Dispute Settlement. *Transnational Environmental Law*. 2018, Vol. 7, No. 2, pp. 2–3.

been involved in the case or not. This could be seen as a broader variation of cross-border chill.[27] Therefore, we can see that defining regulatory chill is not exactly a simple task, but there are common patterns in the various possible categorizations.

As for our own interpretation of how regulatory chill can be categorized, we would argue for that the first two categories in either interpretation roughly carry the same essence, while the third category should likely be separated into two: one for where intimidation of other host states happen (as proposed by the cross-border regulatory chill theory), as well as one where the host state considers its own already concluded ISDS case as the basis for future legislation (a more specific variation of precedential chill theory). In our view, this would provide the fullest view of what can constitute regulatory chill.

In the rest of the section, we examine the following three questions, based on the groundwork laid by the rest of the article: why is ISDS considered threatening enough to result in regulatory chill, what are the supposed consequences of regulatory chill, and finally, what other factors can come into play and potentially undermine its effects. After these questions has been answered, we attempt to propose solutions to regulatory chill in the conclusion of the article.

So, the first element to be discussed is what makes exactly regulatory chill a possibility, what makes ISDS cases so threatening. The answer lies in a multitude of different reasons. First of all, all the issues we presented in the previous section contribute to the notion that investment arbitration is not necessarily to the benefit of the host state. With the table seemingly hedged so much in the foreign investor's favor (at least on the surface), it is not surprising that host states would consider an ISDS proceeding a worst-case scenario for them. In our opinion, this is not surprising at all. But where the true issue lies with are arbitral awards. Especially in the case of developing countries, arbitral tribunals may award damages that could have significant impact

27 Shekhar, S. 'Regulatory Chill': Taking Right to Regulate for A Spin. Working paper [online]. *Centre for WTO Studies*. Published in 2016, pp. 22–24 [cit. 3. 9. 2019]. http://wtocentre.iift.ac.in/workingpaper/'REGULATORY%20CHILL%E2%80%99%20TAKING%20RIGHT%20TO%20REGULATE%20FOR%20A%20SPIN%20(September%202016).pdf

on the host state. A good example of how much funds could be at stake is the *Occidental Petroleum Corporation and Occidental Exploration and Production Company v. Republic of Ecuador (II)* where the foreign investor was awarded 1769 million US dollars.[28] Though this award was partially annulled (with the final damages to be paid becoming a smaller, but still very significant sum), it serves as an excellent demonstration of just how potentially damaging ISDS arbitration can be for a small developing host state. It should also be noted that these countries are also the most reliant on foreign investment. They have little domestic capital, but typically have an abundance of natural resources or a cheap workforce. Thus, for jumpstarting and accelerating their own economic development, they need to "play nice" with foreign investors, or at least appear as tempting business partners. As a result, we can observe that they often cannot afford to antagonize foreign investors, and thus are most likely to consider the threat of investment arbitration either in an anticipatory manner or as a response to a concrete emergent situation. The pop up of precedential or cross-border chill could also be considered possible in these situations. Furthermore, even if the tribunal rules in favor of them, it could serve as a warning sign to other foreign investors that they should not invest in the said country. In our opinion, this could create a potential lose-lose scenario for the developing host state, and contribute to regulatory paralysis, or at least a chilling effect when it comes to legislation.

Next up is considering what are the negative consequences of regulatory chill. In general, regulatory chill has the potential consequence of violating and/or limiting the sovereignty of host states, in relation to a number of different fields. Based on our prior observations, it can be stated that environmental issues are probably one of the fields most likely to be opposed to the interests of foreign investors. In fact, it has recently become a common perspective among environmentalists that regulatory chill could seriously hamper sustainable development in developing countries and hinder progress when it comes to environmental protection.[29] In our view, this problem

28 Occidental v. Ecuador (II) [online]. *Investment Policy Hub* [cit. 11. 9. 2019]. https://investmentpolicy.unctad.org/investment-dispute-settlement/cases/238/occidental-v-ecuador-ii-

29 Neumayer, E. Do countries fail to raise environmental standards? An evaluation of policy options addressing 'regulatory chill'. *International Journal of Sustainable Development*. 2001, Vol. 4, No. 3, pp. 231–232.

is further compounded by the fact that environmental legislation is often the least-developed in developing countries, which would otherwise necessitate a hastened response. The reasons for this opposition should be obvious: environmental regulation necessarily brings increased costs and lengthened bureaucratic processes for affected private entities, including foreign investments. And with the increased importance of environmental protection in many countries, it is a probable situation that during the period that the foreign investment is active, new and stricter environmental regulations would arise in the host state, which in turn would lead to a loss of expected profit. Overall, we can easily mention some examples when environmental policy became opposed to the interests of foreign investors. Two famous cases are *Vattenfall v. Germany* I[30] and II,[31] where a Swedish energy company became opposed to German environmental policy first over a Hamburg coal plant and the supposedly onerous (as perceived by the foreign investor) environmental safeguards implemented by municipal authorities, and secondly over the new German anti-nuclear environmental policy that followed in response to the Fukushima nuclear disaster. Another good example is *Pac Rim Cayman LLC v. El Salvador*[32], where a Canadian mining company came into conflict with the government of El Salvador, as the foreign investor attempted to open gold mines in the host state, but was frustrated by this endeavor by the refusal of the authorities to issue the appropriate mining licenses, based on alleged environmental concerns. There are also cases where environmental policy objectives became entangled with related causes, such as *Ethyl v. Canada*.[33] In this particular case, the issue arose over Canada banning the import of a gasoline additive (known as MMT) that is used in unleaded gasoline, citing both environmental and public health concerns over the substance, which led to an ISDS dispute

30 Vattenfall v. Germany (I) [online]. *Investment Policy Hub* [cit. 12. 9. 2019]. https://investmentpolicy.unctad.org/investment-dispute-settlement/cases/329/vattenfall-v-germany-i-

31 Vattenfall v. Germany (II) [online]. *Investment Policy Hub* [cit. 12. 9. 2019]. https://investmentpolicy.unctad.org/investment-dispute-settlement/cases/467/vattenfall-v-germany-ii-

32 Pac Rim v. El Salvador [online]. *Investment Policy Hub* [cit. 12. 9. 2019]. https://investmentpolicy.unctad.org/investment-dispute-settlement/cases/356/pac-rim-v-el-salvador

33 Ethyl v. Canada [online]. *Investment Policy Hub* [cit. 12. 9. 2019]. https://investmentpolicy.unctad.org/investment-dispute-settlement/cases/16/ethyl-v-canada

with an US chemical company that had a vested interest in the continued Canadian importation of the allegedly dangerous chemical. These cases all show that environmental regulation can be a frequent source for ISDS disputes. However, according to some empirical researches that were conducted in relation to this issue, there is no conclusive proof that environmental legislation is negatively affected by ISDS disputes. But it is also worth mentioning that the very same research also stated that due to the fact that only the adoption of new environmental regulations was examined (and not say changes to existing regulations), this element cannot be understood as the only conclusive proof towards the positive or negative development of environmental protection in a given country, so it is uncertain what the actual practical effects of ISDS are on environmental protection in its entirety.[34] In our opinion, while this empirical research suggests an only tenuous connection (despite its limited scope), it cannot be stated that ISDS has no effect on environmental protection. Given how often environmental policy butts heads with foreign investors, it is unavoidable that the two would end up affecting each other.

While its potential effects on environmental regulation are the most pressing and obvious, ISDS and thus regulatory chill can also theoretically arise in relation to other policy issues. The perfect example of foreign investors coming into conflict with a host state over labour policy is the *Veolia v. Egypt* case,[35] where conflicts arose between the French foreign investor and government of the host state over Egypt's newly enacted labour legislation, which included an increase of minimum wage. The foreign investor perceived this as a violation of the 15-year contract that its Egyptian subsidiary concluded with the governorate of Alexandria, with the aim of providing waste management services within the city. This shows that even the seemingly most innocuous and "normal" labour legislation enacted by the host state can have severe consequences when it comes to foreign investors and ISDS.

34 Berge, T. L., Berger, A. *Does investor-state dispute settlement lead to regulatory chill? Global evidence from environmental regulation*. 2019, p. 22.

35 Veolia v. Egypt [online]. *Investment Policy Hub* [cit. 12. 9. 2019]. https://investmentpolicy.unctad.org/investment-dispute-settlement/cases/458/veolia-v-egypt

And finally, we have to note that proving regulatory chill in a given case is not always simple or easy. Regulatory chill, by its very nature, implies that the host state's policy direction is affected primarily (if not exclusively) by the threat of ISDS proceedings and the consequent arbitral awards. However, in many situations, it is not the only factor by far. Especially in cases involving powerful states that are capable of dealing with the soft sanctions and foreign investment fallout following non-performance of ISDS rewards, such as Russia (infamous for cases like *Yukos Universal v. Russia*[36]) or China, it is truly questionable whether regulatory chill can be realistically considered a primary or even relevant factor when it comes to policy decisions. From another perspective, pariah or otherwise rogue states can also realistically have other considerations besides purely monetary ones when it comes to policy decisions (and potentially can decide to non-perform arbitral awards as well). On the "bright" side, it is clear that in some situation, such as the already mentioned *Vattenfall v. Germany* II, the public interest in a given pro-environment policy is so strong that the host state can potentially feel compelled to see it through, never mind the ISDS consequences of doing so.

Having reviewed the history, and issues of ISDS arbitration, with special focus given to regulatory chill and its many questions, the conclusion will focus on providing suggestions on improving the extant ISDS framework, which could be able to alleviate the regulatory chill-related problems.

5 Conclusion

Throughout this article, we presented the evolution of the ISDS, the issues facing the investment arbitration system, with special focus given to the problem of regulatory chill. Here, in the conclusion, we attempt to provide some suggestions that aim to solve or at least alleviate regulatory chill and some of the other problems.

Regulatory chill is fundamentally a complex issue, arising out from how the framework of ISDS is structured. Thus, in order to prevent its emergence,

36 Yukos Universal v. Russia [online]. *Investment Policy Hub* [cit. 12. 9. 2019]. https://investmentpolicy.unctad.org/investment-dispute-settlement/cases/213/yukos-universal-v-russia

several issues also need to be addressed. But for regulatory chill itself, there is one element that has to be emphasized: the phenomenon allegedly occurs because the host state believes it has much to fear from ISDS. The way to alleviate this is to reiterate and emphasize the states' right to legislate in public interest or to achieve legitimate public policy objectives. Several investment protection treaties already do this, but the issue comes from what the arbitral tribunal will consider "public interest" or "legitimate public policy objective." While the legal bases of ISDS cases do typically contain some guidelines on these, the arbitral tribunals still enjoy a rather large leeway when it comes to interpreting exactly what constitutes public interest or policy objective. Thus, the solution can be twofold: one option is to ensure that future treaties contain a more explicit and clear language regarding these states' rights to regulate, giving significantly less discretionary powers to arbitral tribunals interpreting it. This would also naturally necessitate the updating of many older treaties. The second option is to change how arbitral tribunals themselves interpret these clauses, by establishing some sort of common reference point or a universally accepted guide that provides more clear and concise rules on how these "right to regulate" clauses are to be interpreted in general. Both options can also be used in tandem with each other. The key here is that regulatory chill partially occurs (at least in theory) because the host state is uncertain about how an arbitral tribunal would interpret its legislative attempt. By making it clear and obvious what method of legislation and implementation falls under public interest or legitimate public policy objective, it becomes significantly easier for host states to anticipate whether a given measure would be acceptable or unacceptable for an ISDS arbitral tribunal. In our opinion, this alone would significantly ameliorate this potential issue.

However, there are also other complementary issues that need to be solved. For example, in our opinion, enshrining the host states' right to have counterclaims would be a worthwhile endeavor. While it would be likely a too drastic revision of the ISDS framework to allow host states to initiate disputes and act as plaintiffs; ensuring that they have the ability to present counterclaims against the foreign investor's own claims would be utile and reasonable. In order to ensure that this can happen, it is arguably necessary that

treaties should contain explicit provisions providing for it, so as to ensure that arbitral tribunals cannot dismiss without examination counterclaims based on their own discretionary powers. But as noted previously in the article, it is also necessary to provide the necessary substantive provisions that could serve as a basis for the counterclaims, besides the procedural clauses we already discussed. This would significantly level the playing field in our opinion, and would further reduce the threat ISDS arbitration allegedly represents to developing countries. Another element that we think needs to be addressed is the issue of unclean hands. While this is potentially open to abuse by host states, we believe it would be worthwhile if arbitral tribunals (based on BITs and other treaties) allowed unclean hands exceptions and would examine such matters either in the preliminary phases of the ISDS arbitration (potentially opening up the rejection of the claim altogether) or if that is unviable, a thorough examination at least in the merits phase. In our opinion, unclean hands imply that the foreign investor acted in bad faith, and arbitral tribunals should not take such matters lightly. If the arbitral tribunal sides with the "criminal" foreign investor, it logically leads to increased feelings of resentment and anger at the ISDS system by the general public due to the perceived "injustice". Hence, we believe that arbitral tribunals should be extremely careful around these matters.

Another issue that we believe could be solved is third-party access. As explained previously, it is often not only the foreign investor and the host state's government that are affected by an ISDS dispute, but a whole gamut of different entities and communities. Thus, increasing the role and options of *amicus curiae* in the proceedings seems reasonable. It would be worthwhile to give them greater access to evidence, the ability to participate in the oral debates, etc. The source of much of the antipathy against ISDS stems from its perceived exclusionary and privileged nature. By involving affected parties in the proceedings, by giving them a more serious chance to be heard, and by having the arbitral tribunals consider their grievances and concerns more seriously, we can ensure that the image of ISDS in the public's eyes improves. Of course, it would still be necessary to evaluate whether the third-party has the necessary standing and is closely connected enough to the dispute to be involved. For this, we could perhaps draw inspiration from the various

national civil procedural rules, which often cover third-party access to disputes as well.

Furthermore, enhancing the transparency of ISDS would encourage host states to bring decisions in which public interest prevails over political populism. At the same time, arbitral tribunals will be stimulated to take into consideration the before mentioned unclean hand issues. We can also note that greater public awareness of ISDS internal processes, in combination with the above-mentioned increased access of third parties to the dispute proceeding could further enhance transparency's positive effect. Thus, this could create a synergy between transparency and other issues, allowing significant improvements in all affected issues.

In conclusion, we can state that the future of ISDS still hangs in the balance. As time goes on, criticism mounts, public awareness increases, and the architects of the system will eventually have to rethink just what can be kept and what needs to be changed. Some new treaties, like CETA, discarded ISDS entirely and replaced it with a new system. But many still cling to ISDS, so the future remains uncertain. Nevertheless, solutions and ways to mitigate the system's fallings steadily emerge over time. In our opinion, we can be confident that eventually, some kind of balance will be found between public interest and foreign investment. The only questions are what price it will have and how much time it will take.

Literature

Berge, T. L., Berger, A. *Does investor-state dispute settlement lead to regulatory chill? Global evidence from environmental regulation*. 2019, 41 p.

Bilateral Investment Treaties 1959–1999 [online]. *UNCTAD*. Published in 2000, 142 p. [cit. 3. 9. 2019]. https://unctad.org/en/Docs/poiteiiad2.en.pdf

De Korte, J., Wilts, G. Court allows Russia's unclean hands argument against former Yukos shareholders (Court of Appeal in The Hague) [online]. *Vosdk.nl*. Published on 3 October 2018, 4 p. [cit. 5. 9. 2019]. https://www.vosdk.nl/assets/files/assets/uploads/Court_allows_Russias_unclean_hands_argument_against_former_Yukos_shareholders___1.pdf

European Federation for Investment Law and Arbitration A response to the criticism against ISDS [online]. *EFILA*. Published in 2015, 42 p. [cit. 5. 9. 2019]. https://efila.org/wp-content/uploads/2015/05/EFILA_in_response_to_the-criticism_of_ISDS_final_draft.pdf

Galagan, D., Zivkovic, P. The Challenge of the Yukos Award: an Award Written by Someone Else – a Violation of the Tribunal's Mandate [online]. *Kluwer Arbitration Blog*. Published in 2015 [cit. 8. 9. 2019]. http://arbitrationblog.kluwerarbitration.com/2015/02/27/the-challenge-of-the-yukos-award-an-award-written-by-someone-else-a-violation-of-the-tribunals-mandate/

IBA Arbitration Subcommittee. *Consistency, efficiency and transparency in investment treaty arbitration.* Published in November 2018, 66 p.

Lester, S. The ISDS controversy: How we got here and where next [online]. *ICTSD*. Published in 2016 [cit. 3. 9. 2019]. http://www.ictsd.org/opinion/the-isds-controversy-how-we-got-here-and-where-next

Mohamadieh, K. The Future of Investor-State Dispute Settlement Deliberated at UNCITRAL: Unveiling a Dichotomy between Reforming and Consolidating the Current Regime. *Investment Policy Brief*. 2019, No. 16, pp. 1–14.

Neumayer, E. Do countries fail to raise environmental standards? An evaluation of policy options addressing 'regulatory chill'. *International Journal of Sustainable Development*. 2001, Vol. 4, No. 3, pp. 231–244. https://doi.org/10.1504/IJSD.2001.004446

Nolan, M. D. Challenges to the Credibility of the Investor-State Arbitration System. *American University Business Law Review.* 2016, Vol. 5, No. 3, pp. 429–445.

Investment Policy Hub [online]. *UNCTAD* [cit. 3. 9. 2019]. https://investmentpolicy.unctad.org/investment-dispute-settlement

Parra, A. R. *The History of ICSID.* Oxford: Oxford University Press, 2012, 488 p. https://doi.org/10.1093/law/9780199660568.001.0001

Reform Options for ISDS [online]. *UNCITRAL,* 11 p. [cit. 5. 9. 2019]. https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/uncitral_recs_and_justification_final.pdf

Shekhar, S. 'Regulatory Chill': Taking Right to Regulate for A Spin. Working paper [online]. *Centre for WTO Studies*. Published in 2016, 35 p. [cit. 3. 9. 2019]. http://wtocentre.iift.ac.in/workingpaper/'REGULATORY%20CHILL%E2%80%99%20TAKING%20RIGHT%20TO%20REGULATE%20FOR%20A%20SPIN%20(September%202016).pdf

Tienhaara, K. Regulatory chill and the threat of arbitration: a view from political science. In: Brown, C., Miles, K. (eds.). *Evolution in Investment Treaty Law and Arbitration*. Cambridge: Cambridge University Press, 2011, 746 p. https://doi.org/10.1017/S2047102517000309

Tienhaara, K. Regulatory Chill in a Warming World: The Threat to Climate Policy Posed by Investor-State Dispute Settlement. *Transnational Environmental Law*. 2018, Vol. 7, No. 2, pp. 229–250.

Torbágyi P. *Magyar Kivándorlás Latin-Amerikába az Első Világháború Előtt*. Szeged, 2009, 261 p.

Touzet, J., de Vaublanc, M. V. The Investor-State Dispute Settlement System: The Road To Overcoming Criticism [online]. *Kluwer Arbitration Blog*. Published on 6 August 2018 [cit. 12. 9. 2019]. http://arbitrationblog.kluwerarbitration.com/2018/08/06/the-investor-state-dispute-settlement-system-the-road-to-overcoming-criticism/

Vandevelde, K. J. A Brief History of International Investment Agreements. *U.C.-Davis Journal of International Law & Policy*. 2005, Vol. 12, No. 1, pp. 157–194.

Report of Working Group III (Investor-State Dispute Settlement Reform) [online]. *United Nations Commission on International Trade Law*. Published in 2018, 13 p. [cit. 11. 9. 2019]. https://undocs.org/en/A/CN.9/930/Rev.1