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Investment Treaties, Investor-State Dispute Settlement and Inequality: How International Rules and Institutions Can Exacerbate Domestic Disparities

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Introduction

International investment, and cooperation to facilitate it, can be critical in the fight against inequality and poverty. Cross-border investment activities by MNEs could establish operations and channel capital and technology to areas where it is badly needed, spurring economic growth, job creation, and higher wages. To the extent that IIAs catalyze cross-border investment activity, increasing the pay of low income workers, or increasing the tax revenue that can be used to redistribute wealth, they could help combat intra-national inequality.

However, the more than 3,000 international investment agreements (IIAs) that govern foreign investment, and the investor-state dispute settlement (ISDS) mechanism they contain instead entrench and exacerbate intra-national inequality. They do so in at least two ways. First, they provide covered multinational enterprises (MNEs) greater procedural power than other private individuals and entities under international and domestic law, both with respect to relations with the host state government, and in connection with disputes with other private parties. Second, compounding these privileged procedural rights, IIAs also provide those MNEs enhanced substantive standards of protection that strengthen the legal force of their economic rights and “expectations,” with potentially negative impacts on competing rights and interests held by others.

IIAs and Unequal Procedural Rights for MNEs

Designed to increase investment flows by protecting foreign investors from political risk, IIAs typically: (1) prohibit host states from discriminating against MNEs; (2) require host states to provide MNEs “fair and equitable” treatment; (3) require governments to pay prompt, adequate and effective compensation for MNEs or MNEs’ assets that they expropriate; and, (4) prevent host states from restricting MNEs’ abilities to transfer capital in and out of the country.

Most IIAs give MNEs the extraordinary power to bring ISDS claims against host states to challenge, and seek monetary and other awards for, government conduct that breaches the IIAs’ provisions. This ability to bypass domestic courts and to sue governments directly through supranational systems is exceptional. For one, it represents a fundamental departure from traditional practice under international law. Under most international treaties, only states have had the power to enforce other states’ international law obligations.\(^3\) The international human rights legal framework notably departs from this trend. It allows non-state actors to challenge state conduct, but also requires those seeking to challenge government conduct to first exhaustively seek relief through domestic legal systems before bringing claims through international bodies.

The ability of MNEs to initiate ISDS proceedings is similarly exceptional as compared to the ability of private individuals and entities to challenge government conduct under many domestic legal systems. Domestic jurisdictions typically employ various doctrines that both permit and restrict government exposure to litigation and liability for different types of conduct. They balance myriad policy considerations relating to diverse objectives (e.g., compensating victims, deterring future wrongful conduct, penalizing wrongdoers, and appropriately safeguarding government

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power and resources), reflected in rules and doctrines about who can bring claims, for what kind of harms, with what impact on third parties or future government conduct, what available remedies, etc… IIAs, however, allow MNEs to bypass such domestic legal restrictions by bringing their claims through the ISDS system, in which such domestic procedural rules do not apply. Giving MNEs access to ISDS and the ability to sidestep domestic rules when those rules are adverse to them, and avoid restraints on litigation otherwise applicable to all, gives MNEs greater power than non-MNEs to challenge government action and inaction. Even before an ISDS claim is filed or ISDS decision reached, the mere fact that only MNEs can sue through ISDS can potentially cause the government to devote greater attention and accord greater deference to the preferences and interests of MNEs than the government otherwise would; in some cases, this heightened attention might be to the detriment of competing preferences and interests.4

Take, for example, a situation in which the interests of stakeholder groups diverge. If, for instance, a government decision to issue a permit would be opposed by environmentalists, and a decision to deny the permit would be opposed by an MNE, the agency responsible for deciding which option to pursue may be influenced by knowledge that the environmentalists could not mount a lawsuit challenging the government’s decision but that the MNE could sue the government for vast sums through ISDS. This additional relief mechanism would likely influence the resulting persuasive power of the competing groups.

In addition to giving MNEs greater power than non-MNEs vis-à-vis the government, ISDS also gives MNEs greater power than non-MNEs in legal disputes directly between those two groups. Assume, for example, that a domestic citizen successfully sues an MNE in host country courts for harms caused by the MNE, and is awarded monetary compensation for injuries suffered. The MNE may then be able to turn to ISDS to seek to undo or otherwise eliminate the effects of its court loss. In contrast, if the MNE were to have prevailed in the domestic court proceedings, the domestic citizen would have no similar power to seek a different outcome through ISDS. With access to ISDS, MNEs thus have greater opportunities to get their desired results than their non-MNE opponents do.

Investors’ use of that procedural mechanism to get one more “bite at the apple” may create or exacerbate inequalities between, on the one hand, MNEs and their shareholders and, on the other hand, all other stakeholders without access to ISDS. Investors have used ISDS to contest decisions regarding damages for environmental harm,5 the relative rights of creditors and debtors in bankruptcy proceedings,6 contests over land ownership,7 citizen suits challenging permitting decisions for extractive industry operations,8 the legitimacy of intellectual property protections in the manufacture of generic pharmaceuticals,9 and other unfavorable litigation proceedings and

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7 See, e.g., *Awdi v. Romania*, ICSID Case No. ARB/10/13, Award, March 2, 2015
9 See, e.g., *Eli Lilly v. Canada*, ICSID Case No. ARB/14/2.
outcomes between the MNEs and other private individuals and entities before domestic courts. This disparity in legal power between MNEs with access to supranational ISDS mechanisms to advance their economic rights and interests and other stakeholders without such access can shift the outcomes in discrete cases, and may even shift broader contours of the law in favor of MNEs and away from other stakeholders, diffuse public interests and non-economic interests.

IIAs and Unequal Substantive Rights for MNEs

Beyond the privileged procedural rights that IIAs give to MNEs, enhanced substantive protections included in IIAs further empower MNEs and limit the ability of governments to act in the interests of other stakeholders. Particularly because property rights are a zero-sum game, in which “protecting the resource claims of some parties requires preventing others from using those same resources,” decisions on their definition and scope are a product of a rich history and ongoing contestation. Distributions of economic, social, and political power shape property rights; and, in turn, property rights can shape those distributions of power.

Traditionally, international law has left domestic jurisdictions—and the social forces, political processes, and legal institutions within them—significant latitude to define the scope of property rights and to allocate them among members of society. IIAs, however, have changed that. For instance, rather than merely protecting property rights as defined and redefined through domestic processes, IIAs—and, in particular, their “fair and equitable treatment” (FET) obligations as interpreted and enforced by ISDS—have effectively become tools for creating new property rights to be enjoyed by MNEs. Specifically, arbitral tribunals interpreting and applying IIAs have created a legal doctrine through which they protect certain expectations held by foreign investors regarding future government treatment, and order host states to pay compensation if government conduct deviates from those expectations. Arbitral tribunals thereby effectively convert mere expectations regarding treatment of foreign-owned firms into legally recognized rights enforceable against the state.

Additionally, ISDS decisions are determining the line between permissible laws, regulations and judicial decisions, and arbitrary, disproportionate or other interferences with economic interests that require compensation for lost future profits or other economic “harms”; in many cases, tribunals are drawing those lines differently than domestic legal systems have—even those with strong systems of property rights protections.

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12 Id, 12.
14 ‘Tribunals’ interpretation of the indirect expropriation standard is also relevant; the paper on which this note is based, however, focuses on the FET obligation and its role as a tool for creating new property rights.
15 These determinations are often in connection with tribunals’ decisions on indirect expropriation and non-discrimination.
Compounding these issues, IIAs expressly only seek to protect the rights and interests of MNEs and their owners, with no meaningful opportunity for those who may be adversely impacted by MNEs’ claims to protect themselves. IIA provisions, as interpreted and applied in ISDS, limit the ability of governments to legislate, regulate, or adjudicate in ways that frustrate MNEs’ economic rights and interests; consequently, IIAs and ISDS diminish the competing rights and claims of other stakeholders, undermining efforts to reduce inequality.

These protections can also worsen inequality by entrenching the status quo in the face of reforms to promote greater equity. For instance, the general rule adopted by tribunals is that the doctrine of “legitimate expectations,” interpreted as being part of the FET obligation, protects expectations held at the time the investment is made, including that the legal framework governing or affecting an MNE will not change over time (or will not change much) through court decisions, administrative actions, shifts in policies or practices, changes in legislation or other means of legal evolution.

If subsequent government conduct exceeds the MNE’s “legitimate expectations,” granting more favorable treatment than the MNE had anticipated at the time of the investment, then the MNE keeps those gains; but if the government frustrates the investor’s expectations, the government may be ordered to compensate them for any difference between their hoped-for and actual economic position.

One likely effect will be that, over time, the legal and policy framework will become increasingly favorable to MNEs. Because IIAs typically only permit investors to initiate claims against states (neither states nor other individuals or entities may initiate IIA claims against MNEs), the outcomes of ISDS decisions will generally only be to (1) uphold the property rights of MNEs as they existed under the host state’s domestic law, or (2) expand the property rights protections enjoyed by MNEs under that law. ISDS proceedings will never narrow the property rights enjoyed by covered MNEs under host state law. Thus, beyond the specific effects that protection of investors’ rights and expectations has in a particular case, the structure of the ISDS system is such that, over time, it will lead to a general expansion of the legal protections for MNEs’ economic interests, and corresponding expansion of state (taxpayer) liability for conduct interfering with those interests.

This effect of protecting the status quo against change that negatively impacts MNEs can also entrench or increase inequality among firms by safeguarding the power of market incumbents as compared to new players. If, for example, a government decides to remove or decrease subsidies given to existing businesses (e.g., coal-fired power plants), and/or increase subsidies given to potential new competitors (e.g., generators of renewable energy), that may trigger an ISDS claim by the incumbents. Similarly, if the government passes new environmental or other obligations that would impose new costs on firms, it may proactively exempt incumbents from having to comply so as not to trigger a dispute, thereby favoring incumbents relative to newcomers.

In addition to disadvantaging those competitors without access to ISDS, the ability of MNEs to entrench favorable aspects of the status quo harms other interests that would benefit from

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See, e.g., Tecnicas Medioambientales Tecmed S.A. v. Mexico, ICSID Case No. ARB(AF)/00/2, Award, May 29, 2003, para. 154.
adjustments to law and policy. Notably, MNEs have used ISDS to challenge government efforts to combat three of the most inequality-inducing effects that can arise from property rights systems—negative externalities, abusive practices of monopoly rights holders, and undue appropriation of gains. Investors have used ISDS to, for example, secure compensation for environmental laws and decisions that seek to minimize or avoid environmental externalities;\(^{18}\) regulate tariffs or tackle anti-competitive pricing in provision of public services;\(^{19}\) or limit intellectual property rights, and assess “windfall profits taxes” seeking to capture a greater share of gains derived from the rising price of natural resources (i.e., gains not derived from the investor’s increased efficiency or skill).\(^{20}\) These types of decisions, which are based on a relatively singular focus on MNEs’ economic rights and expectations, do not take into account the broader implications that such protections have for inequality.

**Conclusion**

As described above, IIAs provide MNEs privileged access to procedural remedies and strong substantive protections that favor MNEs’ property rights and expectations, creating and exacerbating inequality among a diverse group of other stakeholders. Furthermore, they allow MNEs to entrench the status quo, favoring incumbents and MNEs’ interests more generally. A number of known ISDS cases illustrates each of these practices and effects, but the extent of the trends has not been well-researched, in part because of the confidentiality of MNE-government interactions and in part of because of the challenge of isolating government motivations.

While further research could dig deeper on the effects of existing international investment governance on inequality, scholars should also explore whether and how IIAs could be enlisted as a tool to combat intra-national inequality. As the system of international economic governance expands, and as intra-national inequality increases, it is crucial to understand the links between the two phenomena and how law can be used to advance, and not undermine, equality.

