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Possible reform of Investor-State dispute settlement (ISDS)

Comments by the Government of Indonesia

Note by the Secretariat

In preparation for the thirty-seventh session of the Working Group, the Government of Indonesia submitted to the Secretariat a brief perspective on ISDS reform. The English version of the paper was submitted to the Secretariat on 29 October 2018. The text received by the Secretariat is reproduced as an annex to this note in the form in which it was received.



Annex

ISDS Reform: a brief perspective from Indonesia

[Original: English]
[Date: 29 October 2018]

A. Introduction

1. This paper aims to present Indonesia's perspective on concerns regarding ISDS. The proposed ISDS reform discussion under UNCITRAL is built upon a substance — procedure dichotomy. In light of this dichotomy, Indonesia sees that it may actually defeat the purpose of having a meaningful ISDS mechanism as it is difficult to separate between substance and procedure.
2. Indonesia is of the view that procedural law is inherently substantive and vice versa. Substantive and procedural provisions in the international investment agreements (IIAs) are intertwined in nature.
3. Further, this paper will elaborate Indonesia's perspective on ISDS reform as a reflection of Indonesia's bilateral investment treaties review that took place between 2014 and 2016.
4. This paper does not prejudice the position that would be taken by the Government of Indonesia in the third phase of deliberation on the solution to be recommended if the reform is desirable by all states.

B. General stand in the process of ISDS reform

5. The ISDS reform process may benefit from the inclusion of all relevant stakeholders, public and private, representing business and non-business interests in the deliberative process to ensure balance and create outcomes that can be broadly accepted by states, investors and third parties alike.
6. The ISDS reform process should reflect an effort to strike a balance between the rights and obligations of all relevant stakeholders, protecting investors and their investments while preserving a state's policy space and right to regulate foreign investments in its territories.

C. Concerns on ISDS that need to be addressed

7. In 2014, after enduring several investment arbitration proceedings, Indonesia took an important decision to review all existing IIAs. The rationale behind such review process was to evaluate the impact of existing IIAs on Indonesia's rights to regulate and pursue legitimate public policy objectives, as well as to modernize IIAs to include principles and provisions that strike a more equitable balance between the objectives of foreign investors and the host state. Concerns towards the ISDS mechanism will be further explained below.

Frivolous Claim

8. It should be noted that claimants in any legal system tend to begin their cases with exaggerated claims of compensation. The exaggerated claim is made in the hope that a less exaggerated but still indefensible amount will seem reasonable by comparison. The gap between claimants' and respondents' valuations tend to be large in an investor-state dispute involving natural resources. This gap requires a complex valuation of businesses and a checks-and-balances system to curb the risk of abuse. The failure of arbitrators to curb this risk results in monumental economic mistakes and states are often the ones paying the price for such mistakes.

9. To address this concern, a guideline should be established, containing a check-and-balances mechanism for claims, an established method for valuation of businesses in accordance with internationally recognized standards in financial reporting, a code of conduct for arbitrators in appraising such valuation, and a mechanism to dismiss frivolous claims at an early stage.

Regulatory Chill

10. There is also evidence to suggest that the threat of ISDS can lead to a “regulatory chill”, where governments become hesitant to undertake legitimate regulatory measures within the public’s interest for fear of claims, thus hindering the government’s right to regulate. Any time a government changes or promulgates new regulations, it exposes itself to potential legal claims by investors. The fear that international arbitration panels decide in favour of the investors may affect governments’ action in carrying out legitimate policy changes in the future. As a result, governments risk losing their policy space and limiting their right to regulate for fear of being put through litigation or facing threats from discontent investors.

Creating a parallel system of adjudication

11. ISDS enables foreign investors to circumvent domestic legal processes and sue the host country in international arbitration. Investors could even challenge the government’s measures that are, in fact, in line with their constitution and laws.

12. Proposals have been made to introduce procedural limitations through the local remedies rule, requiring investors to pursue their claim first through domestic courts before they have access to ISDS (*exhaustion of local remedies*). The relevance of a national administrative court to control state power and uphold the rule of law by providing remedies to regulated entities and persons for state misconduct is being recognized by ISDS tribunals. National administrative courts and ISDS cover similar fact or situation for investors such as failure to accord due process, a wrongful or arbitrary denial of licenses, as well as expropriations and changes in regulatory or tax policies.

Credibility of the international arbitration system

13. Awards issued by investment tribunals are sometimes inconsistent or even contradictory, and there is no appropriate mechanism in place to remedy or limit such inconsistencies. Inconsistent awards could negatively affect the reliability, effectiveness and predictability of the investment arbitration regime and, in the long run, its credibility.

14. A further issue when it comes to the question of independence and impartiality of arbitrators is the switching of roles between arbitrators, counsels and experts in different cases. They sometimes also shift back and forth from their private arbitration practices into public service (double or triple hatting); several arbitrators reportedly have played official or unofficial governmental roles in the negotiation of the very types of IIAs that they adjudicate or litigate in the private sector, resulting in bias perception and lack of independence.

D. Options for ISDS reform

15. Indonesia views that maintaining the conventional approach of ISDS is hardly an option, given today’s criticism of the existing ISDS mechanism. It is therefore suggested that the conventional approach of ISDS be improved in a manner that may effectively reduce state’s exposure to legal and financial risks posed by the ISDS mechanism. Based on Indonesia’s BIT review process, the following may be several references of options on ISDS reform that can be further discussed:

- Providing more safeguards in both substantive and ISDS provisions so that the investor’s rights and obligations could be equitably addressed.

- Allowing investors to make a claim to international arbitration after exhaustion of local remedies.
- Requiring separate written consent as a requirement for an investor to make ISDS claims to international arbitration.
- Introducing mandatory mediation as an alternative dispute resolution before going to ISDS.

Providing more safeguards in both substantive and ISDS provisions so that the investor's rights and obligations could be equitably addressed

16. Excluding ISDS provisions might not be a wise approach, particularly if the main intention is to attract foreign investments. Therefore, Indonesia rather considers a more balanced approach in the context of modernizing its investment treaty template to include more safeguards in both substantive and ISDS provisions. Some safeguards that Indonesia considers important include the definition of investment (asset-based definition with certain exceptions and limitations), covered investment (requiring an admission test in accordance with domestic laws), articles on right to regulate, measures against corruption, corporate social responsibility (CSR), exclusion of claims, general and security exceptions, balance of payments (BoP), prudential measures and public debt.

Allowing investors to make a claim to international arbitration after exhaustion of local remedies

17. Indonesia also considers the option of requiring investors to exhaust local remedies before making an ISDS claim. In addition, states need to strengthen their domestic legal systems by adopting relevant laws and regulations to provide foreign investors with remedies within a reasonable period of time. Exhaustion of local remedies is consistent with customary international law in that they should be a state's first and foremost avenue of resolution before any proceeding of international arbitration may be initiated.

Requiring separate written consent as a requirement for an investor to make ISDS claims to international arbitration

18. In line with the proposed new approach, an international arbitration shall only have jurisdiction to adjudicate an investor-state dispute if the investor concerned and the host state conclude an agreement on submission of investor-state disputes to international arbitration. Indonesia considers introducing a separate consent requirement in the form of a written agreement before an investor could bring a matter to international arbitration. A written consent or special agreement to settle a dispute through international arbitration would be required and would specify the details of the dispute, such as the name and address of the disputing investor, the provisions of the Agreement alleged to have been breached, and the factual and legal basis for the claim. This approach cannot be understood as a way for states to avoid international arbitration altogether.

Mandatory mediation

19. The use of methods other than arbitration to resolve disputes are also considered as potential alternatives to ISDS. States could use tools in their investment treaties to reduce duration and cost proceedings by using alternative dispute settlement, other than arbitration, such as mediation. Indonesia sees mandatory mediation, after the exhaustion of the consultation process, as a way out to prevent a dispute from escalating into a legal dispute which can be costly and damaging to the disputing parties' relationship. Investors, as the case requires, shall seek the assistance of a mediator to resolve disputes once a notification of a potential dispute has been rendered against the state and the consultation process has been exhausted.

20. Indonesia has introduced this mediation procedure in its bilateral IIAs negotiation as an alternative dispute resolution which shall be mandatory for the investors before they can go to ISDS. It is hoped that instituting a formal step in the process will help to raise the profile of alternative dispute resolution processes as an effective alternative given the fractious nature of litigation and international arbitration.

E. Closing

21. The provision on ISDS which has increased a state's exposure to investor claims in international arbitration is one of Indonesia's most significant concerns. It is therefore suggested that UNCITRAL could consider to improve the conventional approach of ISDS in a manner that may effectively reduce unnecessary state exposure to legal and financial risks posed by the ISDS mechanism. On the way forward, much work still needs to be done in this area of inquiry.
