

Gaffney, John P.

Research Report

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Editor-in-Chief: Karl P. Sauvant (Karl.Sauvant@law.columbia.edu)

Managing Editor: Adrian P. Torres (adrian.p.torres@gmail.com)

When is investor-state dispute settlement appropriate to resolve investment disputes?

An idea for a rule-of-law ratings mechanism

by

John P. Gaffney*

Differences exist within the international community regarding the appropriate means of resolving investment disputes, with stakeholders divided over whether such disputes should be resolved by national courts or investor-state dispute settlement (ISDS) (especially by developed countries in the context of the Transatlantic Trade and Investment Partnership). This *Perspective* considers whether there is a role for the creation of a rule-of-law ratings mechanism – involving the issuance of ratings by a designated agency on the degree of respect for the rule of law by domestic courts in a given country or region – in mediating this division, and resolving which dispute-settlement model should be preferred.

The concept of sovereign rating offers a comparable framework for a rule-of-law ratings mechanism. Sovereign rating involves an opinion issued by a credit rating agency (e.g., Standard & Poor's, Moody's) on the creditworthiness of a country, and presented according to a ranking system. These ratings are not uncontroversial, of course, and international regulators are taking steps to reform them. Nonetheless, the sovereign ratings mechanism will remain part of the international economic superstructure.

Why would a similar mechanism be desirable for rule-of-law issues? It is suggested that such a mechanism could help determine when it is appropriate to have investment disputes with a given state resolved by ISDS rather than the domestic courts of that state, where the rating indicates that there is a substantial risk that the rule of law would not be upheld in relation to such a dispute by the domestic courts of the host country.

While credit rating agencies derive their authority solely from the confidence that lenders have in their ratings, a rule-of-law ratings mechanism would require agreement of all the parties to an international investment agreement (IIA). Future IIAs would therefore need to specify alternative investment-dispute mechanisms - comprising both domestic and international dispute-settlement mechanisms - and provide that the choice of appropriate

mechanism would be determined according to the rule-of-law ratings system suggested in this *Perspective*.

In addition to playing a central role in determining whether ISDS is appropriate to resolve investment disputes for a given state, the rule-of-law rating could also serve to incentivize the development of domestic legal systems to a standard whereby investors could be assured that investment disputes would be resolved in accordance with the rule of law. Stakeholders could hardly complain if investors are entitled to invoke ISDS in circumstances in which the host country's domestic courts are unlikely to respect the rule of law in accordance with international ratings by an independent agency.

Such a rating agency is not without precedent. The European Union (EU) Justice Scoreboard, for example, is an information tool published by the European Commission, which aims to assist the EU and member states to achieve more effective justice by providing objective, reliable and comparable data on the quality, independence and efficiency of justice systems in all member states.

The foregoing proposal presupposes that ISDS meets a minimum threshold whereby investors and states alike can be assured that disputes will be settled in accordance with the rule of law. Undoubtedly, the ISDS system suffers from flaws. Hence, the development of a rule-of-law rating would have to proceed hand-in-hand with ongoing reforms of the ISDS.

There would be a number of key issues to be considered in the establishment of such a mechanism, including:

- How would the objective, consistent and reliable criteria on which to base the rule-of-law rating be defined?
- How would the threshold level, beyond which ISDS would no longer be appropriate to resolve investment disputes, be determined?
- How would a ratings mechanism be incorporated into existing or, more likely, future IIAs, to govern the choice of dispute-settlement mechanism?
- Who would act as the relevant ratings agency? Would it be appropriate for a World Bank or United Nations agency to serve in such a capacity?
- How would a rule-of-law rating interact with claims based on denial of justice by the domestic legal system of the host country?
- What should happen in the case of profound political change (e.g., military coup, illegal invasion)? Should the rule-of-law rating be suspended for a defined preliminary period (so as to favor ISDS)?

Whatever the answers to these questions might be, a rule-of-law ratings mechanism could help mediate the current controversy over whether investment treaty disputes should be resolved by national courts or ISDS. Developed countries, whose court systems satisfied the rule-of-law ratings mechanism, would avoid being subjected to arbitration. At the same time, their investors would be entitled to pursue ISDS in developing countries (that failed to satisfy the same criteria), which would be incentivized to develop their domestic courts in a manner that respects the rule of law. Finally, the process of formulating appropriate criteria for a rule-of-law ratings system could in itself make an enormous contribution to the rule of law.

* John P. Gaffney is a Senior Associate at Al Tamimi & Company (United Arab Emirates). The author is grateful to Andrea Bjorklund, Alejandro M. Garro and O. Thomas Johnson for their helpful peer reviews. **The views expressed by the author of this *Perspective* do not necessarily reflect the opinions of Columbia University or its partners and supporters. *Columbia FDI Perspectives* (ISSN 2158-3579) is a peer-reviewed series.**

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For further information, including information regarding submission to the *Perspectives*, please contact: Columbia Center on Sustainable Investment, Alex Weaver, amw2209@columbia.edu.

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