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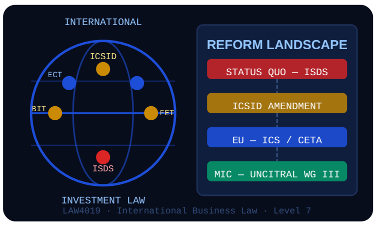

The Legitimacy Crisis in Investor-State Dispute Settlement: Diagnosis and Reform

A Critical Analysis of ISDS under Bilateral Investment Treaties and the Pathways to Systemic Reform

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1. INTRODUCTION

International investment law occupies an uneasy position at the intersection of international economic relations, public law, and arbitral procedure. The system of investor-state dispute settlement (ISDS), constructed primarily through a network of over 2,500 bilateral investment treaties (BITs) and the multilateral architecture of the International Centre for Settlement of Investment Disputes (ICSID),[1] was designed to encourage foreign direct investment (FDI) by providing investors with credible legal protection against arbitrary host-state conduct. By 2023, ISDS claims numbered more than 1,300 across all forums, with awards in excess of USD 130 billion having been rendered against states — including democratic governments acting in the public interest — since the early 1990s.[2]

The scale of this litigation, and the controversies it has generated, have precipitated a widely diagnosed "legitimacy crisis" in ISDS. Critics from across the political spectrum — environmental advocates, human rights lawyers, public health scholars, and constitutional theorists alike — have argued that the current system improperly constrains sovereign regulatory autonomy, lacks democratic accountability, suffers from structural inconsistency, and serves primarily as a mechanism for the appropriation of regulatory space by corporate actors. This essay analyses the structural pathologies that underpin this critique, examines the leading reform proposals advanced by the European Union and the United Nations Commission on International Trade Law (UNCITRAL) Working Group III, and evaluates whether the proposed Multilateral Investment Court (MIC) offers a constitutionally legitimate and practically viable alternative to the status quo.

2. THE ISDS FRAMEWORK: ARCHITECTURE AND INSTITUTIONAL DESIGN

2.1 The ICSID Convention and BIT Network

The cornerstone of the multilateral institutional framework for investment arbitration is the ICSID Convention, which entered into force in 1966 and presently counts 163 contracting states. ICSID provides procedural rules and institutional support for the arbitration of investment disputes, but the substantive rights that generate investor claims are located primarily in the network of BITs concluded bilaterally between capital-exporting and capital-importing states. As Dolzer and Schreuer observe, BITs typically provide the foreign investor with four core protections: fair and equitable treatment (FET); full protection and security; prohibition of unlawful expropriation or nationalisation without prompt, adequate, and effective compensation; and most-favoured-nation (MFN) treatment.[3] The investor accesses these protections by invoking the consent-to-arbitrate clause contained in the BIT, bypassing domestic courts entirely and submitting the dispute to an arbitral tribunal constituted under ICSID, UNCITRAL, or another arbitral ruleset.

The ISDS mechanism was conceived in an era of Cold War concerns about expropriation of foreign assets by newly independent states. Its contemporary application, however, encompasses challenges to a vastly wider range of state conduct: environmental regulation, public health legislation, financial regulation, tax reform, and the restructuring of energy markets. This broadening of scope was not anticipated by the architects of the BIT network and has been a primary driver of the legitimacy critique.[4]

2.2 Substantive Standards: FET and Expropriation

The fair and equitable treatment standard is the most frequently invoked — and most extensively litigated — substantive protection in BIT arbitration. Its content has been developed almost exclusively through arbitral jurisprudence, with different tribunals adopting divergent interpretations. The expansive formulation advanced in *Tecmed SA v Mexico* held that the host state must provide a treatment that does not affect "the basic expectations that were taken into account by the foreign investor to make the investment,"[5] effectively entrenching the investor's legitimate expectations of regulatory stability as a standalone, enforceable obligation.[6] This approach has been applied to protect investors against changes in regulatory frameworks introduced by host states acting in the public interest, producing awards that are difficult to reconcile with orthodox understandings of sovereign regulatory autonomy.

The prohibition on expropriation extends beyond direct takings to "indirect expropriation" — state conduct that does not formally transfer title to an investment but substantially deprives the investor of its economic value. The tribunal in *Metalclad Corp v Mexico* adopted a notably broad conception, finding an indirect expropriation in a municipality's refusal to grant a construction permit for a hazardous waste facility, without regard to whether the municipal authority was exercising a legitimate regulatory function.[7] While subsequent tribunals have refined the analysis — emphasising the character of the governmental act and the degree of interference — the boundaries of indirect expropriation remain contested and the outcome in any particular case is difficult to predict.

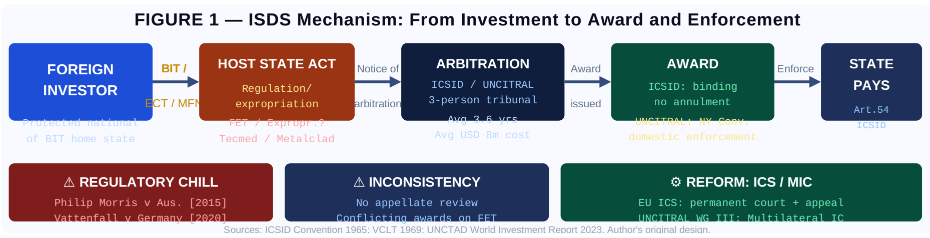

Figure 1: The ISDS mechanism — from foreign investor through BIT/treaty framework to arbitral tribunal, award, and state enforcement. Reform pressure points (regulatory chill,

inconsistency) and proposed solutions (ICS, MIC) are indicated. Source: Author's original design.

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1. *Convention on the Settlement of Investment Disputes between States and Nationals of Other States (opened for signature 18 March 1965, entered into force 14 October 1966) 575 UNTS 159 (ICSID Convention).*
2. *UNCTAD,* **World Investment Report 2023** *(UN Publications 2023) 131–135.*
3. **Rudolf Dolzer and Christoph Schreuer,** *Principles of International Investment Law (2nd edn, OUP 2012) 4.*
4. *Metalclad Corp v Mexico (Award, ICSID Case No ARB(AF)/97/1, 30 August 2000) [111].*
5. *Tecmed SA v Mexico (Award, ICSID Case No ARB(AF)/00/2, 29 May 2003) [154].*
6. *ibid [154]–[156].*
7. *Metalclad Corp v Mexico (n 4) [103]–[111].*

3. THE LEGITIMACY CRISIS: STRUCTURAL PATHOLOGIES OF THE CURRENT SYSTEM

3.1 Regulatory Chill and the Public Interest Deficit

The most politically charged dimension of the legitimacy critique concerns "regulatory chill": the deterrent effect of ISDS liability on legitimate state regulation in the public interest. The concern is that states — particularly developing and middle-income states with limited fiscal capacity to absorb large arbitral awards — will refrain from adopting otherwise desirable regulatory measures for fear of investor claims. Regulatory chill is inherently difficult to measure empirically (states do not typically document decisions not to regulate), but the evidentiary record of tobacco companies using ISDS to resist public health regulation has brought the phenomenon into sharp relief.

In *Philip Morris Asia Ltd v Australia*,[8] Philip Morris restructured its corporate ownership — transferring its Australian assets to a Hong Kong subsidiary — specifically to obtain access to the BIT between Australia and Hong Kong and thereby challenge Australia's plain packaging legislation under ISDS. The tribunal ultimately dismissed the claim on jurisdictional grounds, finding that the restructuring was an abuse of process, as it was carried out with the dominant purpose of gaining access to ISDS after the relevant dispute had become foreseeable. The substantive merits of Australia's public health regulation were therefore never adjudicated; but the litigation imposed years of proceedings and significant legal costs on the Australian government. By contrast, in *Philip Morris Brands Sàrl v Uruguay*,[9] the ICSID tribunal held that Uruguay's tobacco regulations constituted a legitimate exercise of its police powers and did not breach the FET standard — but only after a seven-year arbitral proceeding funded, in that instance, by the Bloomberg Foundation on behalf of Uruguay.

The regulatory chill dynamic is acutely illustrated by Germany's experience under the Energy Charter Treaty.[10] Following the Fukushima nuclear disaster of 2011, Germany enacted legislation accelerating the phase-out of nuclear power. The Swedish energy company Vattenfall, which held investments in two German nuclear power stations, brought ISDS claims under the ECT seeking compensation exceeding €4.7 billion. The claim was settled in 2021 for a confidential sum.[11] The case has generated considerable controversy about the compatibility of ISDS with democratic energy transition policy and has prompted the EU to pursue a reform of the ECT, which ultimately failed to secure agreement, leading the EU and its Member States to begin the process of coordinated withdrawal from the treaty in 2022.

3.2 Inconsistency, Confidentiality, and Arbitrator Independence

A structural deficiency that strikes at the rule-of-law credentials of ISDS is the absence of a binding appellate mechanism capable of ensuring consistency of interpretation across tribunals. Because each arbitral tribunal is constituted ad hoc for a single dispute, there is no doctrine of binding precedent, no institutional hierarchy, and no mechanism for correcting errors of law (other than the narrow annulment procedure under Article 52 of the ICSID Convention, which reviews only for serious departure from a fundamental rule of procedure and manifest excess of powers, not for legal error on the merits).

The consequences for legal certainty are acute. The FET standard, for instance, has been interpreted in mutually inconsistent ways by different tribunals without any mechanism for resolution: some tribunals have applied an autonomous standard broader than the customary international law minimum; others have adopted the NAFTA Chapter 11 approach of tying FET to the minimum standard of treatment under customary international law.[12] Two tribunals constituted under the same BIT have reached opposite conclusions on materially identical facts. This inconsistency is particularly damaging because both states and investors organise their conduct in reliance on the legal framework: unpredictable awards undermine the very stability that ISDS was designed to provide.

Van Harten has advanced a deeper systemic critique, arguing that the structural features of investor-state arbitration — in which arbitrators are selected and remunerated by the parties, are typically drawn from a small commercial arbitration bar with economic incentives to interpret investment protection broadly, and sit without any accountability to a public institution — produce systematic bias in favour of investors over states.[13] Whether or not one accepts the strong version of this critique, the perception of structural partiality is itself corrosive of legitimacy, particularly where the awards bind democratically elected governments on matters of economic and social policy.[14]

3.3 The Achmea Judgment: ISDS and EU Constitutional Order

The most constitutionally significant challenge to the ISDS architecture within Europe was delivered by the Court of Justice of the European Union in *Achmea BV v Slovak Republic*.[15] The CJEU held, by reference to the principles of primacy and autonomy of EU law, that the investor-state arbitration clause in the Netherlands-Slovakia BIT was incompatible with Articles 267 and 344 TFEU. Because the arbitral tribunal constituted under the BIT might be called upon to interpret and apply EU law without being able to refer questions to the CJEU, the arbitration clause undermined the mechanism established by the EU Treaties for the uniform interpretation and application of EU law.[16] The Court ruled that EU law could not permit such a mechanism to operate between Member States.

The consequences of *Achmea* were far-reaching. In 2019, the Member States collectively declared all intra-EU BITs terminated. In *Eli Lilly and Co v Canada*, [17] a similar constitutional tension between arbitral jurisdiction and domestic public law was explored in the NAFTA context, suggesting that the challenge presented by *Achmea* is not unique to the EU's federal legal order but reflects a broader friction between ISDS and constitutional orders that accord primacy to their own legal systems.

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1. *Philip Morris Asia Ltd v Australia (Award on Jurisdiction and Admissibility, PCA Case No 2012-12, 17 December 2015).*
2. *Philip Morris Brands Sàrl v Uruguay (Award, ICSID Case No ARB/10/7, 8 July 2016).*
3. *Energy Charter Treaty (adopted 17 December 1994, entered into force 16 April 1998) 2080 UNTS 100.*
4. *Vattenfall AB v Germany (Award, ICSID Case No ARB/12/12, 2 September 2020).*
5. *Dolzer and Schreuer (n 3) 124–132; North American Free Trade Agreement (signed 17 December 1992, entered into force 1 January 1994) 32 ILM 289, art 1105.*
6. **Gus Van Harten,** *Investment Treaty Arbitration and Public Law (OUP 2007) 5–7.*
7. *ibid 152–153.*
8. *Achmea BV v Slovak Republic (Judgment, Case C-284/16, EU:C:2018:158).*
9. *ibid [59].*
10. *Eli Lilly and Co v Canada (Final Award, ICSID Case No UNCT/14/2, 16 March 2017).*

4. REFORM PATHWAYS: FROM INCREMENTAL REVISION TO INSTITUTIONAL TRANSFORMATION

4.1 The EU Investment Court System (ICS)

The European Union's response to the legitimacy crisis has been to advocate, in its external investment agreements, for the replacement of ad hoc arbitration by a permanent Investment Court System (ICS).[18] Introduced in the Comprehensive Economic and Trade Agreement (CETA) with Canada and the EU-Vietnam Investment Protection Agreement, the ICS features a first-instance tribunal of fifteen publicly appointed members (five from each of the EU, the counterparty state, and third countries) and an appeal tribunal of six members, with permanent tenured appointment on fixed terms, a Code of Conduct for adjudicators, and full public transparency of proceedings and submissions.

The ICS model seeks to address several of the core legitimacy critiques simultaneously: the use of permanent, salaried judges with tenured appointments eliminates the financial incentive to favour investor claims that critics identify in the ad hoc arbitrator model; the appellate division introduces review for errors of law and fact, addressing inconsistency; and transparency requirements expand democratic accountability. The Court of Justice of the European Union has confirmed, in *Opinion 1/17* (CETA), that the ICS as established in CETA is compatible with EU law, addressing the constitutional concerns raised by *Achmea* in the inter-state trade agreement context.[19]

4.2 UNCITRAL Working Group III and the MIC Proposal

At the multilateral level, UNCITRAL Working Group III (WGIII) has been engaged since 2017 in a structured reform process addressing the systemic concerns identified by states. WGIII has proceeded on the basis that there are systemic problems with ISDS warranting multilateral reform and has developed several reform options, including a standing appellate mechanism, revised procedural rules for transparency and costs, codes of conduct for arbitrators, and — most ambitiously — the establishment of a Multilateral Investment Court (MIC).[20]

The MIC proposal envisages a permanent international court with first-instance and appellate chambers, staffed by judges appointed by a conference of states parties, tenured for fixed non-renewable terms to ensure independence, with full transparency of proceedings. The proposal's conceptual architecture draws directly on the model of the World Trade Organisation's Appellate Body, which provided over two decades of relatively consistent jurisprudence in international trade dispute resolution — though the Appellate Body's own institutional difficulties since 2017 temper the attractiveness of this analogy.

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// CRITICAL COMPARISON — ICS (EU) vs MIC (UNCITRAL WG III)
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The EU ICS operates bilaterally and requires each investment agreement to be separately renegotiated. The MIC, by contrast, would operate as a multilateral institution with universal jurisdiction over all ISDS claims brought under treaties that have opted in. The MIC thus offers greater systemic coherence — but demands unprecedented multilateral political will from states with conflicting interests in investment protection.

Table 1: Comparative Analysis of Major ISDS Reform Proposals (2026)

Criterion	Status Quo (ICSID/ UNCITRAL)	EU ICS (CETA model)	MIC (UNCITRAL WG III)
Adjudicator Selection	Party-appointed arbitrators; ad hoc per case	Permanent, state-appointed judges, fixed salary	Permanent, state-appointed judges, multilateral selection
Appellate Review	**✘ None (ICSID annulment only)**	**✔ Full legal and factual review**	**✔ Full legal review; factual review TBD**
Transparency	**Partial (ICSID 2022 Rules improved)**	**✔ Full (UNCITRAL Rules on Transparency apply)**	**✔ Full (UNCITRAL Transparency Rules)**
Consistency of Jurisprudence	**✘ No binding precedent; divergence common**	**Improved — shared appellate body**	**✔ Structural consistency via single appellate chamber**
Scope of Application	All BITs and multilateral treaties (ECT etc)	Bilateral agreements only; renegotiation required	Universal opt-in via single multilateral instrument
EU Law Compatibility	**✘ Intra-EU BIT ISDS invalid (Achmea)**	**✔ Confirmed compatible (Opinion 1/17)**	**Designed to be compatible; details pending**
Prospects for Adoption	Entrenched through existing treaty network	Limited to EU FTA partners; US/China excluded	Ambitious; requires US, China, India participation

Sources: ICSID Convention 1965; CETA, Annex 8; UNCITRAL WG III Reports (2019–2023); Opinion 1/17 (CETA) EU:C:2019:341.

1. *European Commission, 'Proposal for a Regulation Establishing a Multilateral Investment Court' COM(2017) 493 final;* **European Commission,** *'Investment Court System Put Into Practice' (2016).*
2. *Opinion 1/17 (CETA) (Full Court) EU:C:2019:341 [106]–[131].*
3. *UNCITRAL, Report of Working Group III (Investor-State Dispute Settlement Reform), 36th Session (UN Doc A/CN.9/964, 2019) paras 47–68.*

5. CRITICAL EVALUATION AND CONCLUSIONS

The case for reform of ISDS is compelling. The legitimacy critique is not merely a political grievance — it identifies genuine structural deficiencies that undermine the rule-of-law values that the system was designed to advance: consistency, predictability, independence, and accountability. The expansion of arbitral jurisprudence into the regulation of democratic government — driven by an expansive construction of the FET standard, an overbroad conception of indirect expropriation, and the absence of a public interest exception — has produced outcomes that are, at minimum, democratically contested and, in some instances, genuinely incompatible with the regulatory autonomy that international law otherwise accords to sovereign states.

However, the reform debate must grapple with the limits of available solutions. The EU ICS, whilst conceptually sound and legally validated, is structurally bilateral — each future EU investment agreement must individually incorporate the ICS architecture, and the existing network of intra-EU BITs has been terminated without a comprehensive successor mechanism. The MIC offers a structurally superior solution — a single multilateral court capable of providing consistent jurisprudence across the full range of investment treaties — but its realisation depends on political agreement between states whose interests diverge substantially. The United States, which has historically been one of the largest capital-exporting states and which has periodically used BITs and NAFTA Chapter 11 to pursue investment protection claims on behalf of its nationals,[21] has expressed scepticism about the MIC. China, an increasingly significant capital exporter, has adopted a pragmatic posture that has not translated into clear institutional preferences.

A further limitation of the reform discourse is its predominantly procedural character. Both the ICS and the MIC address the process by which investor claims are adjudicated without fundamentally reconsidering the substantive standards — FET and expropriation — that generate the most contested outcomes. As Douglas has argued, the indeterminacy of BIT standards is a problem of treaty drafting as much as of arbitral interpretation: until states agree on precise, circumscribed definitions of FET — linked explicitly to the customary international law minimum standard — and on a regulatory carve-out for bona fide public health and environmental measures, procedural reform alone will not resolve the substantive tensions between investor protection and regulatory sovereignty.[22]

In this respect, the newer generation of EU investment chapters — such as those in CETA and the

EU-UK Trade and Cooperation Agreement — represent meaningful progress: they define FET by a closed list of specific obligations (denial of justice, fundamental breach of due process, targeted discrimination, arbitrary conduct), explicitly preserve the right to regulate in the public interest, and exclude from the definition of indirect expropriation non-discriminatory measures of general application designed and applied to pursue legitimate public policy objectives.[23] These drafting innovations, combined with the institutional reforms of the ICS, represent the most credible currently available template for a legitimate international investment law framework.

In conclusion, the legitimacy crisis in ISDS is both real and remediable. The path to remedy is simultaneously substantive — requiring more precise treaty drafting that embeds a meaningful right to regulate — and institutional, requiring a standing appellate mechanism, permanently appointed independent judges, and full transparency of proceedings. The EU's ICS model advances these objectives bilaterally; the MIC represents the multilateral horizon. Whether that horizon is reachable within a fractured geopolitical environment remains the central question for the next generation of international investment law scholarship and practice.

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1. *Yukos Universal Ltd (Isle of Man) v Russia (Final Award, PCA Case No AA 227, 18 July 2014); Salini Costruttori SpA v Morocco (Decision on Jurisdiction, ICSID Case No ARB/00/4, 16 July 2001).*
2. **Zachary Douglas,** *The International Law of Investment Claims (CUP 2009) 23–25.*

3. *Comprehensive Economic and Trade Agreement between Canada and the European Union and its Member States (signed 30 October 2016, provisionally applied 21 September 2017) [2017] OJ L 11/23, arts 8.9–8.10.*

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