Special Considerations
When a State Is a Party to International Arbitration

Why arbitrating against a state is different: 12 key reasons

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The number of international arbitrations in which states and state entities are parties (state-party arbitrations) has increased considerably in recent years, and is continuing to grow. This growth is a result of the proliferation of bilateral investment treaties (BITs), which mushroomed from about 500 treaties in 1992 to more than 2,000 in 2001. And it is estimated that several hundred treaties have been signed since 2001.

Numerous factors have contributed to the growing number of BITs, among them the “gradual economic interdependence among developed and emergent economies” and the general trend toward globalization. At least one commentator has noted that the fall of the Eastern Bloc (and along with it the theory of absolute state immunity previously ensconced in Communist ideology) has caused new markets to open and new opportunities for investment and, inevitably, new disputes to be resolved.

It is not just the numeric increase in state-party arbitrations that is significant, but also that these arbitrations often involve large sums of money, complex issues, high-profile subject matter and a plethora of national and international interests—economic, political and even cultural.

An arbitration to which a state is a party involves at least 12 special considerations that may make the arbitration different in some ways from an arbitration in which all parties are private commercial entities.

1. States are policymakers, legislators and regulators
2. States make decisions differently
3. A state’s directing mind may be replaced
4. States and their governments have different kinds of interests
5. States answer to different kinds of constituencies
6. States may seek to avoid liability for conduct of state entities
7. States have traditionally enjoyed disclosure privileges
8. State judiciaries are not always independent
9. States have powers to interfere with an arbitration
10. States may have different considerations in their selection of counsel
11. States need to be perceived as having been treated fairly in state-party arbitrations
12. States have broad scope to resist enforcement

Below we discuss each of these considerations and their potential consequences in arbitration for both a state party and a private party. Since each state is different, in any specific case, it is necessary to examine whether and how each consideration may apply.

Participants in arbitration involving a state party must understand the differences between a state-party arbitration and an arbitration between private commercial parties; otherwise they risk being unpleasantly surprised. An appreciation of these differences and their consequences will enable the attorneys to represent their clients more effectively and the arbitrators to conduct arbitrations more effectively.

1. States are policymakers, legislators and regulators
   The fundamental roles of a state include making policy, legislating and regulating. Because of these roles, and the existence of arbitration provisions in BITs and multilateral treaties, a state may become a party to an arbitration for collateral purposes, even if the arbitration is almost certain to fail on the merits. Sometimes the state commences the proceeding; at other times a commercial party commences it. A claimant who brings an arbitration against a state on tenuous grounds may ask for monetary damages when in reality that claimant seeks a shift in policy, or a change in law or regulations. The collateral purpose of an arbitration will be evident in many aspects of the proceeding, including the causes of action asserted, the relief claimed, the kinds of evidence presented, the publicity sought, and the approaches to settlement.

2. States make decisions differently
   State parties make decisions in a different way than do commercial parties. Because states have a broad range of functions (legislative and regulatory) over a wide range of activities, their decision-making processes tend to be cumbersome and bureaucratic. States could have ministries,
ments and/or agencies with different, but inter-connected, roles. Each ministry, department and/or agency is likely to have a multitude of interests and agendas of its own. Rarely are all of these interests the same or even coordinated with each other. One branch of a state may desire the removal of trade restrictions to foster a geopolitical alliance, whereas another branch may seek additional trade restrictions to protect a domestic industry or advance a foreign relations objective, or for another reason. Each branch of a state involved in defending a claim in arbitration may have a different view of the most appropriate way to present the state’s case and/or settle the dispute. In addition, government and quasi-government entities that are closely identified with the state may have different interests in the arbitration from those of the state itself. In states that have a federal system, a disputed issue will be more complex when more than one level of government, or more than one government at the same level, has a policy position on that issue or other interest in it.

Decision making in commercial entities—even large, complex, multinational corporations—tends to be more straightforward. Commercial parties usually arrive at commercially motivated positions with reasonable efficiency.

Bureaucratic conflict and lack of a cohesive state perspective could hamper or even paralyze a state party to an arbitration. This paralysis could present strategic and tactical opportunities for the opposing party. For example, the opponent could try to make allies of dissenting ministries, departments and agencies, or play them off against each other. By taking advantage of the complexity of state decision making, the opposing party might be able to advance its particular objectives in the dispute.

The nature of state decision making also could provide a number of entry points through which an opposing party’s interests could be presented to different branches of the state. These entry points may open a door to attempt to negotiate a resolution of a dispute. Settlement discussions might be held with an appropriate branch of the state, thereby avoiding fruitless discussions with a dissenting branch. Seldom will a private party to an arbitration face a state that has one firm and clear position.

Government employees who decide how the state will respond in arbitration may face pressures and restrictions that differ in nature and degree from those faced by employees of commercial entities. These pressures and restrictions could hamper or even paralyze a state party to an arbitration. This paralysis could provide strategic and tactical opportunities for the opposing party. For example, the opponent could try to make allies of dissenting ministries, departments and agencies, or play them off against each other. By taking advantage of the complexity of state decision making, the opposing party might be able to advance its particular objectives in the dispute.

One restriction placed on state employees in some countries is anti-corruption rules. These rules could make it illegal for state employees to voluntarily settle a dispute on behalf of the state. A failure to fully prosecute all of the state’s possible arguments could result in personal criminal liability.

State parties as well as commercial parties must understand the nature and consequences of the state’s decision-making machinery. A state or state entity involved in an arbitration proceeding can benefit significantly by identifying a clear, unified purpose and trying to overcome its bureaucratic handicaps. One way it could do this is by establishing a steering committee whose members represent all affected interests and whose purpose is to coordinate strategy, resolve differences and instruct counsel throughout the arbitration. By recognizing and dealing with its potential weaknesses, a state should be able to avoid giving its opponent strategic and tactical advantages in the arbitration.

3. A state’s directing mind may be replaced

A state’s government and its political agenda could be replaced by a new government with a different agenda. There are numerous recent examples in different political systems of unexpected changes in government taking place: sur-
prise election results, popular uprisings and revolutionary changes in government are not uncommon. While the process for a change in government varies considerably, depending on the kind of political system in place, the potential for such a change is inherent in all state governments and more likely to occur when there is a long-running dispute.

To the extent that a state’s position in an arbitration is based on the agenda of its current administration, a change in government part way through the proceeding can have dramatic consequences. The positions taken in the arbitration, and the strategies and tactics followed by the state, could drastically and quickly change. The potential for a change in government should be recognized by both parties and it should be considered in their overall strategic and tactical planning.

4. States and their governments have different kinds of interests

State interests can and do differ from the interests of commercial entities. Two interests that tend to drive much government decision making are propagating the government’s political agenda and remaining in power. A state’s position in an arbitration on a politically sensitive issue is usually driven by the government’s political agenda. Examples of such issues abound in investor-state arbitrations, such as those involving the exportation of hazardous waste, the phasing out of a gasoline additive and the construction of a toxic waste processing plant.

Both sides of an arbitration involving a state party need to understand the reason for the state’s position in the arbitration in order to appreciate its tactics—particularly in settlement negotiations. For example, pure financial interests rarely dominate a state’s agenda in arbitration. Thus, arbitration involving a state (unlike commercial arbitration between private commercial parties) usually cannot be resolved by a financial settlement. Those in power may direct that the arbitration be conducted in a manner that will advance a particular political agenda, which could include staying in power. In such circumstances, settlement could depend on the principles involved or the public perception of the proposed resolution.

This does not mean that state parties to arbitration have no monetary interest in the outcome. It means only that states have many interests that are largely noncommercial. For example, a state party to an arbitration arising out of the construction of a factory on its territory may have a direct pecuniary interest in the result of the arbitration, but it may be more concerned with the environmental outcome of the decision or with the fate of the employees affected by the construction.

5. States answer to different kinds of constituencies

Commercial entities are accountable to fewer constituencies than states. A company’s constituency may be only its owners or shareholders, although in some jurisdictions employees may be an important constituency.

The main constituencies of the government of a state party may be the electorate as a whole, members of the political party in power and supporters who helped government leaders attain power, or are helping them stay in power. Governments also must attend to the needs of special interest groups (nongovernmental organizations (NGOs)) and the media.

Special interest groups have considerable political weight and can exert significant influence over government officials. Through lobbying efforts, these groups often are able to pressure one or more government leaders to take particular positions on issues of importance to them in a state–party arbitration.

Confidentiality (sometimes referred to as “privacy” in international arbitration because of its limited scope in some jurisdictions), often a benefit of private commercial arbitration, usually does not exist when a democratic state is a party to arbitration proceedings. A democratic government is accountable to many different constituencies and often makes transparency of government decision making a priority. This objective is
inconsistent with participating in confidential arbitration proceedings. Transparency tends to be linked with good government and accountability in a democratic society. Where transparency is lacking, the process is likely to be met with both skepticism and criticism. Take this commentary published in *The New York Times* on investor-state arbitration under the North American Free Trade Agreement (NAFTA):

Their meetings are secret. Their members are generally unknown. The decisions they reach need not be fully disclosed. Yet the way a group of international tribunals handles disputes between investors and foreign governments can lead to national laws being revoked and environmental regulations changed. And it is all in the name of protecting foreign investors under NAFTA.11

To deflect such criticism, some state parties are encouraging even greater transparency in investor-state arbitration, thereby changing the nature of this type of international arbitration.

A consequence of providing for transparency is the demand of nonparties, like NGOs, to have a say in those proceedings. NGOs brought this issue to the fore when they sought to file “friend of the court [amicus curiae] briefs” in Chapter 11 dispute resolution proceedings under the NAFTA. While Chapter 11 permits a member state that is not a party to the proceedings to file a submission, it does not address whether an NGO may intervene in a NAFTA proceeding. A NAFTA tribunal decided this issue in 2001, when it determined in *Methanex v. United States* that it had the authority to accept amicus briefs from NGOs, and then did so.12

The *Methanex* decision on amicus briefs represents a significant departure from a fundamental characteristic of international arbitration—that the arbitration will involve only the parties to the arbitration. While this decision is almost certain to be limited in the foreseeable future to investment treaty arbitration, at some point there could be pressure to extend nonparty participation to other kinds of state-party arbitrations.

The growth of transparency and participation of nonparties in investment treaty arbitration demonstrate that having demanding constituencies can have powerful consequences, including transforming state-party arbitrations into semi-public dispute resolution proceedings. This occurred in *United Parcel Service of America v. Government of Canada*,13 where the jurisdictional hearing and a significant part of the merits hearing were held in public, with a live video feed available for members of the public to watch in another room.

6. States may seek to avoid liability for the conduct of state entities

Many states create state entities to carry out commercial and/or regulatory activities for the state. The conduct of a state entity may give rise to a claim that the state entity has caused a breach of an investment treaty. States usually resist the assertion that they are responsible for the acts of such entities. Some treaties, such as the NAFTA, address this issue directly through provisions like Chapter 15, which deal expressly with state entities. In investor-state arbitrations, tribunals have increasingly relied on the principles set out in the International Law Commission’s Draft Articles on State Responsibility, which are widely regarded as codifying international law on attribution. Article 5 of the Draft Articles provides that the conduct of a person or entity that is not an organ of the state but is empowered by the law of that state to exercise elements of governmental authority shall be considered an act of the state, provided that person or entity is acting in that capacity in the particular instance. In one recent decision, a tribunal attributed the commercial acts of an entity empowered by the state to the state itself.14

7. States have traditionally enjoyed disclosure privileges

It is common today to require parties to disclose documents and statements of fact and expert witnesses to each other at a relatively early stage of the arbitration.15 However, in the case of state parties, such disclosure requirements can be troublesome.

Many states are accustomed to the privilege of not disclosing information. In Canada and many other parliamentary democracies, for example, the parliamentary privilege protects the speech of members during parliamentary proceedings. A cabinet privilege similarly protects the speech of cabinet ministers. These privileges generally protect records of these discussions from disclosure in domestic legal settings.

These privileges, which may be taken for granted by states in domestic situations, are becoming less effective in the context of international arbitration. It is increasingly evident that attempts by a state party to avoid producing information on the basis of these kinds of privileges will meet resistance on the international stage.

In *United Parcel Service*, Canada claimed cabinet privilege for several hundred documents. The tribunal accepted that the privilege may apply domestically but not in the context of the law governing the tribunal. The tribunal stated:
[A] claim for Cabinet privilege “would have to be assessed not under the law of Canada but under the law governing the Tribunal.” That law does not in this context refer the Tribunal to national law. Further, [the Canadian statutory provision] in its own terms does not apply to this proceeding since the Tribunal does not have “jurisdiction to compel the production of information.”

Canadian domestic law merely requires the Clerk of the Privy Council to declare a document to be privileged in order for it to be so. In United Parcel Service, the tribunal required a more explicit and open analysis before it might be willing to find that the privilege applied to specific documents. Specifically, it directed Canada to do the following: first, make an explicit initial judgment regarding the privileges to be protected with respect to each individual document, then explicitly weigh each judgment against the public’s interest in disclosure. These two steps would ordinarily be undertaken by the Clerk. Once these steps were completed and the result submitted to UPS and the tribunal, the tribunal could rule on whether cabinet privilege applied.

In this case, the tribunal found that the claim to a cabinet privilege was not made out. As to the consequences of nondisclosure, the tribunal said that “[a] failure to disclose, found by the Tribunal to be unjustifiable, may lead to the Tribunal drawing adverse inferences on the issue in question.”

We expect that the ways in which arbitral tribunals handle state claims of traditional nondisclosure privileges will continue to evolve.

8. State judiciaries are not always independent

Some states do not have an independent judiciary. If the commercial party to a state-party arbitration seeks relief in the state’s courts, a state-influenced or -controlled judiciary could use unfair procedures and issue unfair rulings. A judiciary that is not truly independent could play a part in arbitration between commercial parties, but the potential for interference is greater in an arbitration involving a state.

The tactics that might be applied by a judiciary controlled or influenced by its state government are not difficult to imagine. These tactics are seen more frequently than might be expected, even in states that are not notorious for a lack of judicial independence. A state-controlled court could issue an injunction or other order to stop, delay or hamper the arbitral proceedings, or interfere with the arbitrators themselves. Even if the order is withdrawn later or reversed in an appeal process, the speed of the arbitration would be impeded, and the position of the commercial party may be prejudiced.

Other tactics a judiciary that lacks independence might employ include impeding access to state documents, interfering with witnesses and reviewing the arbitral award in a manner that is not impartial.

Having to arbitrate with a state that lacks an independent judiciary should greatly concern a commercial party. Before commencing arbitration, it should consider the implications of potential judicial interference on the strategic and tactical decisions that it might make concerning the arbitration, including its approach to settlement negotiations and the prospects and strategies for enforcement of an award or settlement agreement.

9. States have powers to interfere with an arbitration

States possess a wide variety of powers that they could use to interfere with an arbitration. The most significant of these powers are so-called national security powers, including powers of search and seizure, and arrest and detention. These powers could be misused to influence, persuade, intimidate or threaten witnesses or principals in an arbitration. The search and seizure power also could be used to seize materials important to the commercial party, including evidence, property or even counsel’s work product.

A state has the ability to interfere with an arbitration using a host of administrative powers. For example, it could refuse to issue (or could delay) visas for witnesses in order to handicap the commercial party’s preparation or presentation of its case. It also could expropriate property.

This is not to say that a commercial party could not use improper tactics. However, state
parties can do so in many more ways, and with relative impunity, particularly when undertaken under the guise of security or administrative functions.

In the developed world, the abuse of state powers in arbitration is seldom seen. However, that does not mean it could not occur. Even in the most advanced and open democracies, there have been well-known instances of abuse of state power. The bottom line is that a commercial party to an arbitration with a state should be aware that the potential for misuse of state power exists.

10. States may have different considerations in their selection of counsel

Commercial parties to arbitration with a state are not limited in their selection of counsel. Generally, they select counsel on the basis of competence and experience.

States may have different considerations when selecting counsel. The choice of counsel may have consequences for the conduct of the arbitration, the role of counsel and the role of the arbitral tribunal.

Political considerations might dictate that a state be represented by a lawyer who works for the state or, at a minimum, one who is admitted to practice in the state. In some states, the higher the domestic profile of the case, the greater the pressures to select counsel from that state. Sometimes the choice of the state’s counsel in an arbitration may be guided by political affiliation or patronage. Sometimes financial resources may make a state unable to employ counsel who is experienced in international arbitration. All of these considerations could lead to the retention of counsel without the necessary expertise in international arbitration—a choice that would not be in the state’s best interests.

When one of the attorneys in an international arbitration is less than qualified, both parties and the tribunal suffer the consequences. The efficiency and timing of the arbitration would likely be adversely affected. The tribunal may need to compensate for poor representation by inexperienced counsel (obviously in a manner consistent with its obligation to treat the parties equally and fairly). One commentator has stated that a party should be held to “a high standard in direct proportion to its presumed sophistication and the presumed competence of its counsel.”

Often, one branch of a state has the responsibility for retaining and directing counsel representing its interests in the arbitration. The commercial party and its counsel should determine which branch that is and how its interests might diverge from the interests of other branches of the state. The directing branch’s interests may produce a strategy that other branches may call into question as the arbitration progresses. It behooves counsel for the state to be alert to the interests of other branches of the state, not only the interests of the directing branch.

11. States need to be perceived as having been treated fairly

While both commercial parties and states expect fair treatment from arbitrators, states are subject to greater pressure from their constituencies when they are involved in investor-state arbitration. Investment treaties and their dispute resolution provisions are the result of states wishing to increase foreign investment within their borders. However, the concept of investors making direct claims against sovereign states is a significant change from notions of state sovereignty. State parties to investment treaties now feel the financial, political and other pressures as a result of the investment treaty arbitration mechanism. Therefore, it is vital to states that they feel that the tribunal treated them fairly and that their domestic constituencies perceive that the tribunal treated them fairly.

Many arbitrators in investment arbitrations recognize that these pressures exist. One experienced arbitrator observed that some arbitrators have taken on the role of “guardian” of the state’s interests to ensure not only that justice is done but also that justice appears to be done.

[You will find the tribunal doing a number of things which may be very frustrating to the claimant but in the end are designed by the tribunal to insure that the award it ultimately renders is, in fact, accepted as legitimate by the parties and can be enforced by any relevant national court. Thus you will see, for example, a “bending over backwards” by the tribunal as it deems necessary...]

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In addition, to the extent a state party may give evidence of reluctance to participate in the proceedings, the tribunal is likely to extend itself to the end that the state is persuaded to remain fully active in the proceedings and thereby give them maximum legitimacy. For these reasons, a tribunal may grant objectively unwarranted extensions of time or permit the filing of additional memorials, even following the expiration of a “firm” deadline.

Thus, in the eyes of the arbitrators, states may
appear to be “more equal” than others. Counsel for commercial parties to state-party arbitration should be prepared for this attitude and make sure that their clients are not materially disadvantaged by it.

We are not suggesting that arbitrators in investor-state arbitration are biased toward states. Rather, we mean that some experienced arbitrators will try to minimize the potential for attacks on the award by trying to eliminate potential arguments of procedural injustice. The overriding principle governing the tribunal’s role in state-party arbitration is first and foremost one of perceived impartiality and justice. But the need for legitimacy in the eyes of the state party and states generally could influence how arbitrators conduct state-party arbitrations.

There is a great need for highly qualified arbitrators in investor-state arbitration. This has led to the creation of a pool of experienced arbitrators with a known track record. Some arbitrators have become known as being either state-friendly or investor-friendly. (This kind of polarization is generally not seen in international commercial arbitration.) Therefore, both parties to an investor-state arbitration need to consider that track record when selecting the arbitrators. Knowledge of the background and experience of arbitrator candidates and attention to the general process of selecting arbitrators are even more important in these arbitrations than in arbitrations between commercial parties.

12. States have broad scope to resist enforcement

States are sovereign entities, generally enjoying immunity from claims of all types. As a consequence, if an arbitral award is rendered against a state, the real battle may have only just begun. Enforcing an award against a state can present a challenge since states have an array of measures to resist enforcement of arbitral awards. The most notable demonstration of this challenge can be seen in the arbitrations against Argentina, which has resisted honoring a number of awards against it.

Following an economic collapse in 2001, Argentina defaulted in the payment of its foreign debt, and converted foreign currency bank deposits and credit into pesos. This led to the filing of dozens of arbitration claims by investors. Faced with this onslaught of claims, which, if upheld and enforced could affect the renegotiation of Argentine debt, the Argentine government challenged the entire BIT arbitration regime administered by the International Center for the Settlement of Investment Disputes. Argentina has contemplated seeking review by its courts of the arbitral awards rendered against it on constitutional and subordination grounds.

Argentina’s response to these arbitration awards shows the impetus of states to resist the enforcement of arbitral awards favoring foreign investors. It also shows that state sovereignty remains a significant factor when a state is party to an arbitration.

True, arbitrators have ruled, and courts have agreed, that a submission to arbitration implies an explicit or implicit waiver of sovereign immunity. However, this waiver applies only to the state’s immunity from suit and liability. Most BITs do not contain waivers of immunity from enforcement of arbitral awards. Thus, while sovereign immunity from liability is not a bar to an arbitral award against a state where such immunity has been waived, if the state has not waived its enforcement immunity, enforcement of the award remains problematic. Moreover, not infrequently it may be difficult to find exigible state assets to satisfy an award against a state.

For example, in Canada, § 12 of the State Immunity Act reiterates the general principle that property of a foreign state that is located in Canada is immune from execution unless certain exceptions are satisfied. The most important exceptions are that (1) immunity from execution has been waived, and (2) the property is “used or intended for a commercial activity.” Thus, absent an explicit waiver of enforcement immunity, commercial property is virtually the only property upon which awards can be enforced in Canada.

Thus, despite the growth of investor-state arbitration, a prevailing commercial party often faces a significant hurdle in the absence of voluntary payment of an award by a state. Enforcement immunity remains a significant consideration in state-party arbitration.
Conclusion

Because each state is different, in any particular situation it is necessary to examine whether and how each of the considerations discussed in this article may apply and affect each party to the state-party arbitration.

To represent clients effectively, counsel should understand the differences between international arbitration involving a state party and international arbitration between commercial parties in order to represent their clients effectively. The failure to do so can lead to unpleasant surprises.

ENDNOTES

1 In this article, the term “states” includes entities that are sufficiently connected to a state so that the special considerations applicable to states are applicable to these entities as well.


3 See Nigel Blackaby, “Public Interest and Investment Treaty Arbitration” in van den Berg, ed., supra n. 2, at 356. See also Lalive, supra n. 2.

4 See generally Hobér, supra n. 2.


6 Id.

7 The phenomenon of arbitration brought for a collateral purpose is less common in arbitration involving only commercial parties.


9 Methanex Corp. v. United States of America (NAFTA Ch. 11), available at www.state.gov/s/l/c5818.htm.


12 Methanex, supra n. 9, Decision of the Tribunal on Petitions from Third Persons to Intervene as “Amici Curiae,” Jan. 15, 2001 (NAFTA Ch. 11), available at www.state.gov/documents/organization/6039.pdf.


16 Supra n. 13, at ¶ 7.

17 Id. at ¶ 15.


19 Id.

20 Id.


22 Id. at § 12(1) (a).

23 Id. at § 12(1) (b).