

Does the International Investment Regime Induce Frivolous Litigation?

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Abstract

The treatment of foreign investment has become the most controversial issue in global governance. At the centre of the controversy lies the mechanism of investor-state dispute settlement (ISDS), which allows private firms legal recourse against governments, if government interference has degraded their investment. Using newly released data covering 696 investment disputes, I assess some of the central claims about ISDS. I argue that the regime has indeed undergone a major shift: a majority of claims deal not with direct takings by low rule of law countries, but with regulation in democratic states. The result of this shift towards indirect expropriation affects firms' incentives: claimants may gain even when they lose a challenge, if litigation can deter governments' regulatory ambitions. The result, as I show, is an increase in the number of cases, accompanied by a precipitous decrease in their legal merit. Investors bringing indirect expropriation claims also appear far less likely to settle, and more likely to publicize the dispute, consistently with theoretical expectations.

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1 Introduction

The treatment of foreign investment has unexpectedly become the most controversial issue in global governance. In fact, one would be hard pressed to think of another instance, since the abandonment of the gold standard, where so many countries have walked back their international commitments in a given issue-area. Today, two major transatlantic trade agreements are in jeopardy over their investment provisions.¹ France and Germany, in particular, are fielding unprecedented domestic backlash against the proposed investment measures.² Australia vowed not to sign any further agreements with investment provisions. Indonesia is promising to revise all its investment treaties, of which it has signed over 60.³ Brazil and South Africa are opting out of the international investment regime, stating that they will rely on domestic alternatives instead.⁴ Ecuador and Bolivia have formally withdrawn from the investment regime's central tribunal.⁵ In sum, the pushback against the investment regime is no longer a fringe phenomenon: it includes developed as well as developing, democratic as well as non-democratic countries. At the centre of the controversy over investment rules lies the mechanism of investor-state dispute settlement (ISDS).

ISDS allows private companies to bring legal claims against a host government. If the government's actions are found to have degraded the company's investment in breach of an investment treaty, the company can be awarded financial compensation. Criticism of ISDS converges on an alleged disconnect between the original aim of the mechanism and its current use.⁶ Modern investment rules emerged in the post-colonial era as a way of protecting Western investors from expropriation and nationalization by governments in countries with weak rule of law. Yet since the mid-1990s, these observers claim, the ISDS mechanism has progressively been used against developed countries that already feature strong domestic judiciaries, in ways that are threatening these countries' ability to regulate for the public interest. A string of high profile cases where multinational companies have challenged German nuclear bans, Australian tobacco regulations, and Canadian fracking moratoria have added fuel to such concerns.

¹The EU is conducting negotiations in the Comprehensive Economic and Trade Agreement (CETA) with Canada, and in the Transatlantic Trade and Investment Partnership (TTIP) with the US. In both cases, the investment chapter constitutes the agreement's greatest point of contention.

²"Germany Expresses Concerns About US And Canada Trade Deals". *FT*. <http://on.ft.com/1BbQ0bz>.

³*Jakarta Post*. <http://www.thejakartapost.com/news/2015/05/17/the-week-review-investor-state-dispute.html>.

⁴"The Arbitration Game". *The Economist*. <http://www.economist.com/news/finance-and-economics/21623756-governments-are-souring-treaties-protect-foreign-investors-arbitration>.

⁵"Foreign-Investment Disputes: Come and Get Me". *The Economist*. <http://www.economist.com/node/21547836>.

⁶Lester 2013; Schultz and Dupont 2014; de Mestral 2015; Chen 2015.

In response, policymakers frequently point out that investors lose most of the claims they bring, and that ISDS thus poses little true threat to legitimate governmental regulation.⁷ Yet this leads to an overlooked puzzle: why would investors continue to file these costly cases, if the expected success rate is so low? As I show, the puzzle is only sharpened when one takes a closer look at the data. Current estimates actually *overstate* investors' success rates, especially when it comes to specific types of legal claims. What is more, this rate of success has been dropping precipitously over time—the opposite trend to the one we observe in inter-state disputes in the trade regime over the same period.

Scholars have a role to play in this debate, yet until recently, they have lacked the means of engaging in it. Data about investment disputes is notoriously sparse. Successive institutional reforms promise to increase transparency,⁸ yet parties can still choose to keep details of a dispute largely private. Moreover, the lack of a multilateral investment institution⁹—arbitration is scattered across a number of different venues—has meant that for a long time there was no centralized database of investment disputes. The result is that until recently, there has been little means of empirically assessing the conflicting claims put forth in the policy debate. The picture has improved of late, with several parallel data collection efforts now underway.¹⁰ In this article, I rely on what is to my knowledge the first claim-level dataset of ISDS litigation, which covers all 1421 individual claims across 696 investment disputes from 1993 to present day.

By leveraging this claim-level aspect of the data, I address the most prevalent concerns surrounding the ISDS regime. The findings suggest that the investment regime has indeed changed in its primary purpose since its origins. Most disputes today are not over direct takings, but over *indirect* expropriation. And most respondent-countries are not rent-seeking regimes with low rule-of-law, but stable democracies with independent judiciaries. To put it in stark terms, the greatest portion of legal challenges in the investment regime today seek monetary compensation for regulatory measures implemented by democracies.

Indirect expropriation differs in a number of ways from direct expropriation, starting with the fact that the expropriating state usually derives no revenue from the alleged expropriatory act. I argue that the incentives also differ from the standpoint of the firm. Specifically, firms can use litigation to temper governments' regulatory ambitions. This is in part because investor-state

⁷“Incorrect claims about investor-state dispute settlement”. European Commission. 3 October 2013. <http://trade.ec.europa.eu/doclib/html/151790.htm>.

⁸Hafner-Burton, Steinert-Threlkeld and Victor 2014.

⁹On the difficulties in arriving at a multilateral agreement to codify investor rights, see Wellhausen (2014).

¹⁰See Schultz and Dupont 2014; Wellhausen 2015; Franck 2007; Allee and Peinhardt 2011, Tucker 2015.

litigation is costly to governments: not only are the legal costs significantly higher than in, e.g., trade litigation, but investment flows appear to suffer from litigation, even when the government ultimately wins the case.¹¹ As a result, firms may benefit from spillover effects of the challenges they bring forth. When Philip Morris challenged Australia’s labeling regulations, New Zealand put its own labeling legislation on hold, and Philip Morris loudly praised the decision.¹² If litigation exerts a sufficient deterrent effect, firms may benefit even when they lose a case. The result is an increased likelihood of frivolous litigation, where the purpose of a challenge is not so much to win and obtain compensation, as it is to deter regulation.

How would we know if frivolous litigation were taking place? Studies of legal outcomes invariably come up against the twin challenge of observability and selection. We can only observe those cases that come up. Without knowing what policies were prone to challenge, any analysis risks selection bias. While selection is an often insurmountable issue, here I seek to use it to my advantage, by formulating expectations over the outcome of those cases that one does observe, given that one knows selection is occurring.

Specifically, if investors are rationally selecting cases that carry varying deterrent effects, then one can derive expectations over the likely success rate of these different types of claims. If indirect expropriation claims are especially likely to carry positive spillover effects from the investors’ standpoint, then one would expect that for a given level of (low) legal merit, investors would be more likely to file an indirect expropriation claim than a direct expropriation claim, all else equal. As a result, those indirect expropriation claims that are observable should obtain lower rates of success in litigation. Secondly, if the goal is in part to deter the respondent and other countries, rather than to resolve the underlying dispute, then one would expect indirect expropriation claims to be associated with lower rates of settlement, and be more likely to drag out until a ruling is rendered. Variation in the publicization of disputes allows for a third theoretical expectation: if investors derive some additional benefit from deterrence through indirect expropriation claims, then these should be less likely to be kept private, the better to deter further regulation.

Findings relying on recently released UNCTAD data covering investment disputes from 1993 to 2015 offer support for these specific beliefs, and further document a broad shift in the investment regime. While the “explosion” of investment disputes has been widely recognized,¹³ what I show is that the legal merit of these disputes has steadily dropped over time. This trend is

¹¹ Allee and Peinhardt 2011.

¹² Philip Morris Press Release, Feb. 19, 2013. “Philip Morris International Comments on New Zealand’s Standardized Packaging Announcement”.

¹³ Simmons 2014; Allee and Peinhardt 2011.

especially apparent when it comes to indirect expropriation. I argue that the record of investment disputes is consistent with the view that the regime is growingly being used to challenge domestic regulation, and that one unintended effect we are seeing is an increase in frivolity over time. Firms are litigating more and more, and they are winning less and less. To wit, investors win less than 10% of the indirect expropriation claims they bring against democratic countries. The design of the regime, which allows private standing, contributes to the trend: compared with analogous regimes like international trade, it features little of the restraint that exists in dispute settlement between sovereign states.

The findings also provide additional support for two corollary beliefs. The regime's overall level of transparency, in spite of attempts at improvements through institutional reforms, has been decreasing, rather than increasing, which concords with recent findings.¹⁴ And legal capacity appears to play an important role in countries' ability to defend themselves from legal challenges, spurring concerns about distributional effects. Wealthier countries do far better in litigation, winning disputes at a significantly higher rate than less wealthy countries.

The alleged disconnect between the original aims of ISDS and its current application matters not only for the policy debate, but also for theory. Much of the academic literature on investment rules appears vested in an era where the regime was designed to protect investors from direct takings by non-democratic governments. Yet as I go on to show, most claims today are leveled against democracies, and most concern indirect expropriation arising from regulation, rather than "sovereign theft". This shift away from direct takings holds important implications for any attempt to account for the odds of expropriation across countries and time. Resource-strapped regimes might be more likely to expropriate, and this may be most likely to occur in high output sectors, and during periods of high commodity prices¹⁵—but this would only be true for direct takings. The majority of disputes in the investment regime today concern expropriatory acts that would have netted the government no actual revenue. On the other hand, indirect expropriation might be a greater concern in developed democratic regimes where domestic audiences expect high standards of protection over the environment and public health. In sum, in assessing the validity of the common criticisms of the investor-state regime, this article finds itself questioning some of the central assumptions underlying the study of investment in IPE.

¹⁴Hafner-Burton, Steinert-Threlkeld and Victor 2014.

¹⁵Cole and English 1991; Li and Resnick 2003; Tomz and Wright 2010; Jensen et al. 2012; Pelc and Urpelainen 2015.

2 Ancient Regime, Recent Changes

That the property of foreign investors cannot be taken by a government without the payment of “prompt, adequate and effective compensation” is a well established point of customary international law.¹⁶ In his discussion of property rights, Hugo Grotius had already elaborated a theory of expropriation by the mid-17th century.¹⁷ The ISDS regime itself is also far from new: its broad outlines were first elaborated in 1959, in the Draft Convention on Investments Abroad.¹⁸ That ‘first draft’, in turn, largely restated existing customary rules over the treatment of aliens.¹⁹ Countries have since gone on to sign over 3000 bilateral investment treaties, and 60 trade agreements with investment chapters, the majority of which rely on some form of investor-state arbitration.

Given this long history, it is somewhat unexpected that the protection of foreign investment has recently become the object of so much public attention. Policymakers themselves often appear taken aback by this development. After noting that of all the issues in its trade negotiations with the US, investment—and specifically, ISDS—“has received the most attention and raised the most concern”, the EU Commissioner for trade, Cecilia Malmström, recently noted that “In some ways that’s surprising. Over 60 years, national governments in the EU negotiated 1400 bilateral investment treaties without any outcry.”²⁰ The lead Canadian negotiator, Steve Verheul, also admitted that opposition to ISDS came as a “significant surprise”.²¹

Yet the exact contours of what constitutes expropriation have never been as hazy as they are today. What legal scholars *do* agree on is that the concept of expropriation has progressively moved beyond direct takings of property by governments, and gone on to encompass other acts that have effects “equivalent to” such takings. The concept of indirect expropriation is not new, either, but its frequent invocation *is*: Escarcena (2014, 6) aptly describes it as a “dormant issue” in international law. A rich jurisprudence from the first half of the 20th century deals with expropriation, chiefly through rulings of the Permanent Court of International Justice (PCIJ),

¹⁶The commonly referred to phrase calling for “prompt, adequate and effective compensation of expropriation” comes from the so-called Hull formula, drafted by Cordell Hull in the wake of Mexico’s nationalization of American oil interests in 1936.

¹⁷Reynolds 2010.

¹⁸Also referred to as the Abs-Shawcross convention, for its two authors, Hermann Abs a German national, and chairman of the Deutsche Bank, and Hartley Shawcross, a British national and director at Royal Dutch Shell.

¹⁹These rules were supported by the jurisprudence of courts that had long ruled on matters of expropriation, such as the Permanent Court of International Justice (Pauwelyn, 2014; Fitzmaurice and Tams, 2013).

²⁰“Opening remarks: Discussion on Investment in TTIP”. 18 March 2015. Cecilia Malmström, Commissioner for Trade. Brussels Meeting of the International Trade Committee of the European Parliament.

²¹“EU Quietly Asks Canada To Rework Trade Deal’s Thorny Investment Clause”. Janyce McGregor. CBC News. Jan 21, 2016.

but these come short of considering indirect expropriation.²² The wide array of terms currently used today to describe this alternative type of expropriation—“indirect expropriation”, “disguised expropriation”, “tantamount expropriation”, “creeping expropriation”, “measures equivalent to expropriation”, “*de facto* expropriation”—speaks to how the concept remains unsettled in law.

Expropriation is indirect when it does not involve a transfer of property, but nonetheless deprives the investor of the enjoyment of her property, such as when regulation degrades the value of an investment. Yet as one of the main arbitrators in the ISDS regime puts it, “international law has yet to draw a bright and easily distinguishable line between regulation and expropriation, especially indirect expropriation”.²³ The majority of cases in the investment regime now fall under this still ambiguous area of law, which is also at the source of the current public outcry.

The other concurrent reason for the sudden increase in public attention is the sheer volume of litigation. While the ISDS regime is nominally over 50 years old, the majority of cases brought over the regime’s entire history have been filed in the last decade. For all intents and purposes, states and multinationals are dealing with a new legal recourse option.

Figure 1 illustrates both these trends. The UNCTAD dataset I rely on begins in 1993. But if the timeline were stretched further back in time, litigation activity would be seen to sputter at its minimum level from the early 1970s to 1996, when it suddenly picks up, as seen in Figure 1.²⁴ The chart shows how the volume of both direct and indirect expropriation cases has increased in time, but how the increase in indirect expropriation cases has been more pronounced. The main takeaway, however, is that the past two decades are dominated by indirect expropriation claims. It is worth mentioning that indirect and direct expropriation claims are effectively mutually exclusive. They are highly negatively correlated; only 2% of all known cases include both claims. Even in that handful of cases, they function as “in the alternative” claims, such that no single arbitral tribunal has ever found a breach under both claims in the same case. Since 1993, 71% of all cases have featured an indirect expropriation claim, while only 17% have featured a direct expropriation claim. Indirect expropriation is thus the most commonly invoked claim in investment disputes in the last twenty years, alongside claims of fair and equitable treatment, with which it is often packaged.²⁵ By comparison, national treatment claims are brought 3 times less often, and most-

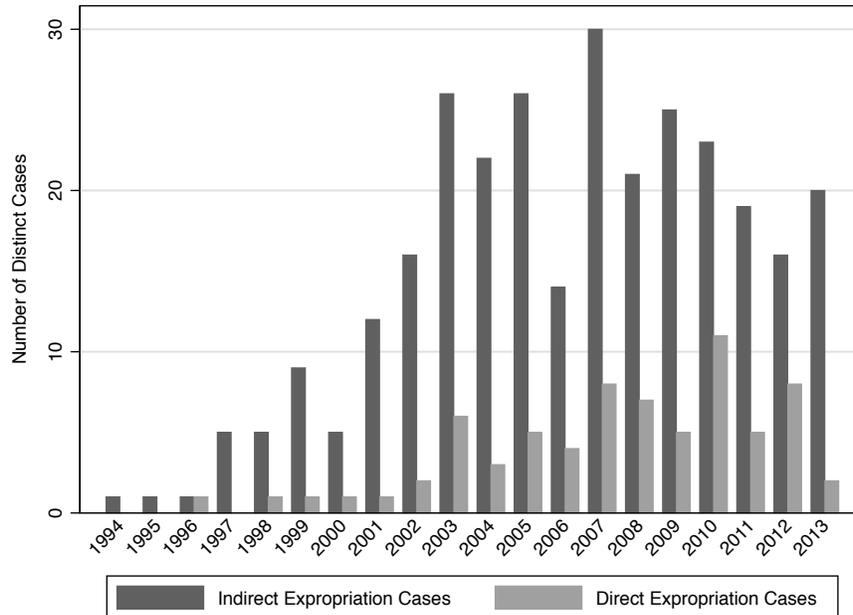
²²Fitzmaurice and Tams 2013. One possible exception may be found in the *Chorzów Factory* case, over Poland’s taking over of a German-owned factory. The PCIJ ruled that the exploitation of patents and licenses associated with the factory were prejudiced by the taking, since those rights “were, so to speak, concentrated in that factory”. But even in that case, the indirect expropriation directly resulted from the taking of the factory.

²³Fortier and Drymer 2004, 299.

²⁴See Schultz and Dupont 2014, whose data cover fewer disputes, but stretching farther back in time.

²⁵As Dolzer (2005, 87) puts it, the fair and equitable treatment clause is “in its substance closely related to the

Figure 1: Direct vs. Indirect Expropriation Claims in ISDS



Source: UNCTAD Investment Dispute Settlement Navigator 2015.

avored nation claims are brought 4 times less often than indirect expropriation claims. In other words, the current investment regime is not chiefly concerned with discrimination.

Figure 1 and the analyses below are based on recently released data from UNCTAD’s Investment Dispute Settlement Navigator.²⁶ The goal of this considerable data collection effort is to document all publicly known disputes launched under an international investment agreement. It only deliberately excludes disputes that arise out of commercial contracts or domestic investment legislation. Its resulting coverage includes 696 investment disputes.²⁷ Launched in late 2015, it is to my knowledge the most complete database of investment disputes for the period it covers, and the only one to code disputes at the claim level. By comparison, a recent empirical analysis by a prominent legal scholar relies on 159 disputes.²⁸ In other words, these data come closest to representing the full universe of investment disputes in what remains an otherwise opaque setting.

Concerns over ambiguous distinction between non-compensable regulation and expropria-

more specific standards of an indirect expropriation”, and is often added to “round out the case”. It is a more general, “catch-all” provision that indirect expropriation. In the analysis, I ensure that the findings are robust to inclusion of the fair and equitable claim.

²⁶UNCTAD 2015. <http://investmentpolicyhub.unctad.org/ISDS/>.

²⁷Some of these disputes offer only partial information, a trait that I exploit in the analysis below.

²⁸(Franck, 2014).

tion arose as soon as the ISDS regime emerged, even if they have only recently reached a peak level. The first step taken towards ISDS, in the 1959 Draft Convention on Investments Abroad, already raised red flags among legal scholars. The concerns of the time read as if they could be written today. In 1960, the legal scholar Stanley Metzger warned:

“Since the drafters chose to depart from the ‘taking’ language, they intended to prohibit measures constituting something less than a taking [...] Thus, a regulatory measure may indirectly deprive a person of property [...] by taxing the property more, curtailing his disposition of property at any price he sees fit, etc.”²⁹

Metzger concluded that countries would never allow themselves to bargain away their regulatory powers in such a way: “For the reasons described [...], countries are and will continue to be unwilling so to commit themselves.”³⁰ This prediction proved wide of the mark. If anything, the regime has progressed towards far greater delegation. For instance, while the Draft Convention required the consent of the host country for litigation to proceed, no such consent is needed in the modern ISDS regime. The concerns voiced today remain the same as in Metzger’s time, but claims of indirect expropriation have now become the norm. The investment regime has yet to deal with the difficulty of distinguishing non-compensable regulation from expropriatory acts that demand compensation.

While the possibility for indirect expropriation was already present in that first 1959 draft, the North American Free Trade Agreement (NAFTA) was instrumental in making it a frequent legal recourse by firms. Its investment section, Chapter 11, innovated by covering acts “tantamount to” expropriation: Article 1110 begins,

“No Party may directly or indirectly nationalize or expropriate an investment of an investor of another Party in its territory *or take a measure tantamount to nationalization or expropriation* of such an investment (‘expropriation’).”³¹

That clause, in turn, drew heavily on US domestic law over regulatory takings, which recognized that “if regulation goes too far it will be recognized as a taking.”³² Litigation under NAFTA also generated what is likely the most expansive legal interpretation of indirect expropriation, in the *Metalclad* case from 2000, as including:

²⁹Metzger 1960, 141.

³⁰ibid

³¹NAFTA Article 1110. Emphasis added. The Energy Charter Treaty, which brings together 54 members, including Russia and the EU, features a highly similar provision to NAFTA in its Article 13.

³²The phrase is from Supreme Court Justice Brandeis’ famous 1922 dissenting opinion in *Pennsylvania Coal Co. v. Mahon*. See Fortier and Drymer 2004.

“... not only open, deliberate and acknowledged takings of property, [...] but also covert and incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of the property *even if not necessarily to the obvious benefit of the host state.*”³³

This last condition, obviating the requirement for some gain on the part of the state, confirmed that the expropriatory effect could be entirely incidental to the regulation at issue. The government need neither *intend* to expropriate, nor *gain* from doing so, for a measure to be deemed expropriatory. The *Metalclad* award is often favorably cited by claimants in indirect expropriation disputes across the investment regime.³⁴ Yet arbitral tribunals have not always sided with such a broad interpretation. Other awards have given more weight to the government’s ability to regulate for the public good. Two years after *Metalclad*, the arbitrators in another dispute against the same country and under the same agreement, *Feldman v. Mexico*, emphasized this point:

“governments must be free to act in the broader public interest through protection of the environment, new or modified tax regimes, the granting or withdrawal of government subsidies, reductions or increases in tariff levels, imposition of zoning restrictions and the like. Reasonable governmental regulation of this type cannot be achieved if any business that is adversely affected may seek compensation”³⁵

The takeaways from *Feldman v. Mexico* were that public interest could be used to distinguish valid regulation from a compensable taking, and that the requirement for compensation in such cases could hamper reasonable regulatory efforts. Both these points clash with the *Metalclad* award. In sum, there remains considerable ambiguity as to what constitutes indirect expropriation, and what distinguishes it from non-compensable regulation. Yet one thing is plain: this ambiguous provision has become the investment regime’s bread and butter. Indirect expropriation provisions are also present in the most recently concluded large deals between states. The Trans-Pacific Partnership’s (TPP) investment section, for instance, defines indirect expropriation as occurring whenever “an action or series of actions by a Party has an effect equivalent to direct expropriation without formal transfer of title or outright seizure”.³⁶ In this article, I argue that as the regime

³³Emphasis added. United Mexican States v. Metalclad Corporation, ICSID Case No. ARB(AF)/97/1, Aug. 30, 2000. in Fortier and Drymer 2004.

³⁴See, for instance, *InterTrade v. Czech Republic*, where the claimant cites the interpretation of indirect expropriation in the *Metalclad* award to support its own “de facto expropriation” claim.

³⁵Marvin Roy Feldman Karpa v. Mexico, ICSID Case ARB(AF)/99/1, Dec. 16, 2002. in Fortier and Drymer 2004.

³⁶TPP Investment Chapter, Annex 9-B: 2.

has shifted away from protecting investors against direct takings, and concerned itself primarily with indirect expropriation, it has also affected investors' incentives in a way that has regime-wide repercussions.

Beyond its greater legal ambiguity, another aspect of indirect expropriation points to the need for a re-evaluation of current theoretical expectations in the study of investment. Indirect expropriation most often offers the host state no short term windfall. In the case of direct takings, when governments nationalize foreign assets, or forcibly transfer title, they gain the value of those assets. In fact, for some time, the enrichment of the host state was one test by which a tribunal might recognize whether expropriation had taken place. Not so in the case of indirect expropriation, where an investment's value is most often degraded without it benefiting the host state. When Indonesia banned open-pit mining in protected forests, when Germany decided to phase out nuclear energy by 2022, when Australia imposed plain packaging on cigarette makers, the state did not derive any direct financial benefit. Conversely, when Venezuela, in 2007, nationalized all oil projects, including profit-sharing projects that had until then been exempted from the prior 2001 Hydrocarbons Law, it gained the entire value of the associated rights over oil exploration and production.³⁷

Another way to put it is that direct expropriation happens because of the presence of an investment, while indirect expropriation happens despite the presence of an investment. This remains an approximation: rogue governments can use creeping legislative measures in bad faith to purposefully degrade the value of investment—consider Russia's treatment of the energy firm Yukos.³⁸ And governments might seek to get out of onerous commitments to firms through regulatory means. Yet it remains accurate to say that on average, direct expropriation brings expropriating governments some short-term financial gain, while indirect expropriation most often does not.

The evolution of case law offers support for this view. The rise of indirect expropriation claims is the very reason cited for the rejection in case law of the requirement that for a measure to be expropriatory, it must enrich the host state.³⁹ The reasoning behind the change was that to require proof of enrichment would peremptorily “negate the protection against indirect expropriation”, since in most cases, indirect expropriation gives rise to no such benefit.⁴⁰

³⁷See *Mobil v. Venezuela*, ICSID Case No. ARB/07/27.

³⁸Yukos Universal, incorporated in the Isle of Man (UK), brought the case at UNCITRAL against Russia under the Energy Charter in 2005. See Gibson 2015.

³⁹For an exception, see the ICSID decision in *Olguín v. Paraguay*, where the arbitrators put forth both an enrichment and a purpose test, which led them to find in favor of the state on all claims. This exception has had no following.

⁴⁰Fortier and Drymer 2004, 314.

These distinctions hold important implications for theory. A growing literature in international political economy examines the investment regime. Many of these studies rest on a view of the regime as offering protection from “banditry” or “sovereign theft”, usually by autocratic regimes.⁴¹ Yet such measures are no longer representative of expropriation. Simple descriptive statistics serve to illustrate the point. Using the conventional cutoff for democracy of a Polity score of 7 and above, a full 64% of investment disputes in the last two decades target democracies. Even during this period, the percentage of targeted democracies has been rising over time, especially for specific types of legal claims. When scholars examine the circumstances under which expropriation grows most likely, they usually focus on the benefit to government of seizing assets. In this way, Cole and English (1991) build a model where expropriation is likely when output prices are high. Jensen et al. (2012, 8) view “expropriations as a form of redistribution during crisis”, and argue that the temptation to expropriate thus peaks during crises, even as the constraints on expropriation also increase during these periods. Pelc and Urpelainen (2015) base their model on the way in which the (financial) gains from breaches in the investment regime accrue directly to the government, rather than to import-competing firms, as in the case of the trade regime. These expectations no longer comport with the super-majority of alleged breaches in the investment regime, since indirect expropriation most often does not bring the government any windfall revenue. The type of expropriation that these studies have in mind constitutes only 17% of the ISDS regime’s entire caseload over the last two decades. In sum, the investment regime’s shift towards protection against indirect expropriation has considerable implications for studies of the regime.

Finally, that there has been a shift, and that this shift has been unexpected, is supported by the fact that the default remedy in the investment regime is monetary compensation, rather than compliance. As Pauwelyn (2014, 410) argues, when dealing with direct expropriation, awarding “damages as standard remedy makes sense”. Not so “when it comes to treaty claims against public laws or regulations.” Indeed, in most domestic legal regimes, regulatory breaches are remedied through compliance. The designers of a regime where the standard remedy is monetary compensation would have had in mind disputes over direct takings. The regime has strayed from that expectation. Next, I consider the regime from the investor’s standpoint.

⁴¹Li and Resnick 2003; Tomz and Wright 2010; Jensen et al. 2012.

3 Frivolous Litigation in the Investment Regime?

One defining trait of the ISDS regime is the way in which it allows for private standing. That is, private firms or individuals can themselves bring suit against governments. This distinguishes investment from international trade, where there is an emphatic rejection of private standing, or any mechanism reminiscent of it,⁴² and where only states can challenge one another's policies. This feature of ISDS is, according to some, consistent with rational design: governments' credibility problem with regards to investors is such, that a high level of enforcement is required.⁴³ Others describe it instead as a "historical accident": an unplanned, incidental development, rather than an essential one, the main intent of which was to keep commercial disputes from spilling over into interstate relations.⁴⁴

Regardless of its origins, private standing, as a design feature, eliminates an important source of restraint against raising legal challenges, by doing away with reciprocity. Looking at the trade regime, there is considerable evidence of tit-for-tat filing in the international trade regime.⁴⁵ As a result, countries that anticipate a legal challenge in response to their own filing often choose not to file. Generally speaking, legal challenges between sovereign nations come at considerable political cost. Japanese trade officials claim that they are regularly stifled in their litigation efforts against China by the Japanese Ministry of Foreign Affairs, from fear of inflaming political tensions between the two countries. The continued interaction between states in a forum such as the trade regime means that belligerent countries' reputations may suffer. Firms have less reason to exercise diplomatic restraint. The only cost they face from a legal challenge is the cost of counsel—which in the case of the investment regime, in particular, remains quite high. Yet they need not worry about possible retaliatory challenges, or the reputational costs of belligerence. Quite the opposite, a reputation as an aggressive claimant may work to a multinational company's net benefit.

Private standing has long been a feature of ISDS, and thus it cannot, by itself, explain a recent shift in the volume of litigation, or the nature of those claims. Rather, the point is that as the perceived gains from litigation increase, the design of the investment regime does not have in place the natural barriers preventing an "explosion of cases".⁴⁶ Investors are likely to launch a

⁴²One of the greatest controversies to erupt around WTO dispute settlement concerned amicus briefs, over the question of whether the panel or Appellate Body could accept written submissions from non-state actors if it deemed these relevant to reaching a positive solution to the dispute. In other words, WTO members are highly suspicious of any private party involvement.

⁴³Simmons 2014.

⁴⁴Pauwelyn 2014, 404.

⁴⁵Davis and Bermeo 2009; Feinberg and Reynolds 2006.

⁴⁶Simmons 2014.

case whenever the cost of legal counsel is outweighed by the benefits of litigation. Next, I examine the nature of those costs and benefits.

3.1 The Cost of Investment Disputes

The argument hinges in part on the high cost of litigation to governments. In the case of the World Trade Organization, the cost of litigation is often mentioned as a reason countries ultimately decide not to challenge an offending trade barrier.⁴⁷ Yet the cost of investment disputes is far higher. In a 2010 report, UNCTAD admitted that “[c]ontrary to the expectations [...] costs involved in investor-State arbitration have skyrocketed in recent years.”⁴⁸ There is every indication that these costs have only kept increasing since. In the case of ICSID, a recent estimate finds average costs per dispute of USD\$ 5.5 million for governments since 2011.⁴⁹ This is about 5 times more than the average WTO dispute, which is the same ratio by which arbitrators’ fees at ICSID outstrip panelist fees at the WTO.⁵⁰

From the state’s standpoint, the costs of litigation are not limited to legal fees. Allee and Peinhardt (2011) show how investment disputes can undo much, if not all, of the benefit of international investment agreements as measured by investment flows. Crucially, this effect is present *even if* governments ultimately prevail in the dispute. This appears consistent with findings from the trade law literature showing that the initial announcement of a WTO challenge, by itself, increases the attention paid to the relevant industry by domestic audiences.⁵¹ Because international disputes are costly actions, they are usually thought to be credible indicators of rent-seeking behavior by states.⁵² Yet if a large proportion of disputes in the investment regime are of low merit, this no longer holds. Frivolity jeopardizes a regime’s information-gathering function.

The takeaway relevant to the argument is that governments have an incentive to avoid litigation, *even if* they believe they will ultimately prevail on the merits. This incentive will be highest for developing countries, for whom these costs, both in terms of legal fees and lost investment flows, are relatively more onerous. Next, I consider the benefits of litigation from the standpoint of the firm.

⁴⁷See e.g. Davis 2012; Busch, Reinhardt and Shaffer 2009.

⁴⁸“Investor-State Disputes: Prevention and Alternatives to Arbitration”. 2010. UNCTAD Series on International Investment Policies for Development.

⁴⁹Commission (2016) finds that average ICSID costs to governments from FY2011 to FY2015 were USD\$ 4 954 461, and total tribunal costs, which are usually split between parties, were of USD\$ 882 668.

⁵⁰Pauwelyn 2015, 23. And arbitrators sometimes turn down ICSID cases in favor of UNICTRAL cases, where fees are higher still.

⁵¹Pelc 2013.

⁵²Mansfield, Milner and Rosendorff 2002.

3.2 Regulation and the Threat of Litigation

Frivolous litigation occurs when legal challenges are filed despite low odds of success.⁵³ If rational claimants file a case knowing that it is of low legal merit, it may be because litigation itself brings some other benefit. In the case of indirect expropriation, I argue that the additional benefit derived from litigation is the possibility of tempering governments' regulatory ambitions. Popular accounts have associated indirect expropriation claims with the threat of "regulatory chill", yet the reasoning behind these claims is often murky. Here I seek to assess it more systematically.

Direct takings are idiosyncratic in a way that regulation is not. A direct expropriation occurs in a highly specific context. Meanwhile, regulation has a tendency to spread across countries. A large literature on diffusion attests to how countries learn from one another's policies in arriving at their own policy profile.⁵⁴ In the same way, governments may draw conclusions about the desirability of policies by seeing these attacked in high profile disputes. Public health and environmental initiatives across different countries growingly rely on the same scientific standards, as is the case with smoking laws, nuclear energy, and fracking legislation, to refer to cases that have attracted most attention in recent years.⁵⁵ The result is that while it is not inconceivable that direct expropriation challenges might carry a deterrent effect—if only by demonstrating willingness to litigate—this becomes far more likely in the case of indirect expropriation.

The second reason to think that indirect expropriation claims are especially prone to regulatory chill is the one mentioned above: because measures subsequently judged to be indirect expropriations most often bring the government no revenue, the threat of costly litigation may be a more effective deterrent than in the case of direct expropriation, where a government may simply tally the expected cost of arbitration against the current value of expropriation. By comparison, regulatory initiatives prone to indirect expropriation challenges rarely come out on top from such cost-benefit calculations. And because of the international aspect of regulation, and of the multinational aspect of the firms that act as claimants, such a deterrent effect may actually be felt across borders.

There is disagreement among scholars about the likelihood of the ISDS regime generating an effect of this sort, though as mentioned, the idea is highly salient in the public debate. Among legal scholars, some affirm that the investment regime "has serious potential to prevent the adoption

⁵³Accordingly, the legal literature sometimes refers to frivolous litigation as "low-probability litigation". For a review of findings on frivolity in the domestic civil justice system, see Guthrie 2000.

⁵⁴See, among others, Simmons and Elkins 2004; Post 2005; Lazer 2001.

⁵⁵See *Philip Morris v. Australia*, *Philip Morris v. Uruguay*, *Vattenfall v. Germany*, and *Lone Pine v. Canada*.

of a regulatory measure with public purposes”,⁵⁶ while others warn that “proof is very scarce”⁵⁷, though they go on to admit that it is more likely for developing countries.

There actually exists considerable anecdotal evidence of investment arbitration, or the threat of such arbitration, affecting government behavior in a way consistent with a regulatory chill hypothesis. When Canada attempted to enact tobacco legislation similar to the one that Australia implemented before being hit by a series of legal challenges, it faced threats of ISDS disputes from the tobacco industry on two occasions, in 1994 and 2001. In both cases, it ultimately backed down from the proposed law.⁵⁸

When Indonesia tried to ban open-pit mining in protected forests, mining companies threatened to launch investment disputes under the Aus-Indo and UK-Indo BIT.⁵⁹ Indonesia backed down and exempted foreign mining investors from the proposed ban, even though legal observers noted that the threatened arbitration claims would have had little chance of succeeding.⁶⁰ But the threat proved sufficiently compelling: as the Indonesian Environmental Minister admitted, “There were investment activities before the Forestry Act was effective. If shut down, investors demand compensation and Indonesia cannot pay.”⁶¹

In the Canadian and the Indonesian cases, the potential deterrent effect of the indirect expropriation challenge was felt in the respondent country. But the same effect can conceivably spill over across borders. New Zealand has long contemplated a similar plain packaging tobacco law to the one implemented by Australia. When Australia’s legislation was challenged in both trade and investment venues, New Zealand suddenly suspended the proposed legislation.⁶² Philip Morris rejoiced. It praised New Zealand’s decision as “demonstrat[ing] that the New Zealand government recognizes the significant international trade issues with standardized packaging and will not implement it until the pending international legal challenges to Australia’s law are resolved.”⁶³ Nor are these spillovers likely to be limited to New Zealand. As in other cases, developing countries are the most prone to deterrence, given their inability to muster sufficient legal resources to counter ISDS challenges. In the case of tobacco regulation, these countries are concentrated in Africa, where the

⁵⁶Chen 2015.

⁵⁷de Mestral 2015.

⁵⁸Tienhaara 2011; Lencucha, Labonte and Drope 2015.

⁵⁹Tienhaara 2011.

⁶⁰Gross (2002) performs a careful analysis of the likely claims claimants might have brought against Indonesia—on indirect expropriation and fair and equitable treatment—and assesses their merits on the basis of analogous cases.

⁶¹in: Gross 2002, 895.

⁶²The Health Minister Tariana Turia stated “the Government will wait and see what happens with Australia’s legal cases, making it a possibility that if necessary, enactment of New Zealand legislation and/or regulations could be delayed pending those outcomes.”

⁶³See *supra*, note 12.

tobacco industry's growth potential is highest. Namibia, Gabon, and Togo have all faced threats from the industry in reaction to plans for tobacco regulations. As the World Health Organization's director general put it, existing legal challenges "are deliberately designed to instil fear in countries wishing to introduce similarly tough tobacco control measures."⁶⁴ Namibia's proposed regulations was the most ambitious of the group, but in the face of threatened litigation, it has thus far come short of implementing any provisions from the proposed law. As the Namibian Health Ministry behind the legislation put it, "the fear is that they [the tobacco industry] have the money and they have the resources, so they can pay for anything".⁶⁵

In sum, there are a number of salient cases where challenges of indirect expropriation, or the mere threat thereof, appears to have successfully swayed policy outcomes in host states.

3.3 How Might We Recognize Frivolity?

To systemically assess frivolity, one would ideally observe all potential breaches of countries' investment obligations, and the merit of each, and see which ones are challenged. One could then ask whether the legal merit threshold beyond which investors choose to file a case is lower for indirect expropriation claims than for measures that give rise to a claim of direct expropriation. If so, then one could conclude that frivolous litigation is more likely in indirect expropriation claims.

Yet observing all measures open to challenge, even within a single state, is not feasible. The result is that analyses that consider only those breaches that were challenged expose themselves to selection bias: any observed effect may be reducible to firms' calculation to file the claim or not. Rather than trying to address the problem head-on by looking for a set of potential cases that were not challenged, one can think about the expected composition of the sample of observable claims, given that we know selection is occurring.

3.3.1 Expectations Over Legal Merit

How are claims chosen? Investors deciding whether to bring a claim against a government perform a specific cost-benefit analysis. On the one hand, they weigh the expected value of a claim: the amount of compensation multiplied by the odds of success. To this, they add any benefit derived from deterring regulation. On the other hand, they consider the cost of litigation, which one can

⁶⁴ "The Changed Face Of The Tobacco Industry". Keynote Address at the 15th World Conference on Tobacco or Health Singapore. 20 March 2012.

⁶⁵ "Tobacco Firms' Strategy Limits Poorer Nations' Smoking Laws". *New York Times*. Sabrina Tavernise, Dec. 13, 2013.

assume is constant across claim types. The resulting testable expectation is that if indirect claims do give rise to a higher deterrence benefit, then the average legal merit of those indirect claims that *are* filed should be lower, all else equal. Investors will require a lower level of legal merit to file a case, if they think doing so has a chance of staving off regulation. The result is that we should expect lower odds of a pro-claimant finding for those indirect expropriation claims that are filed.

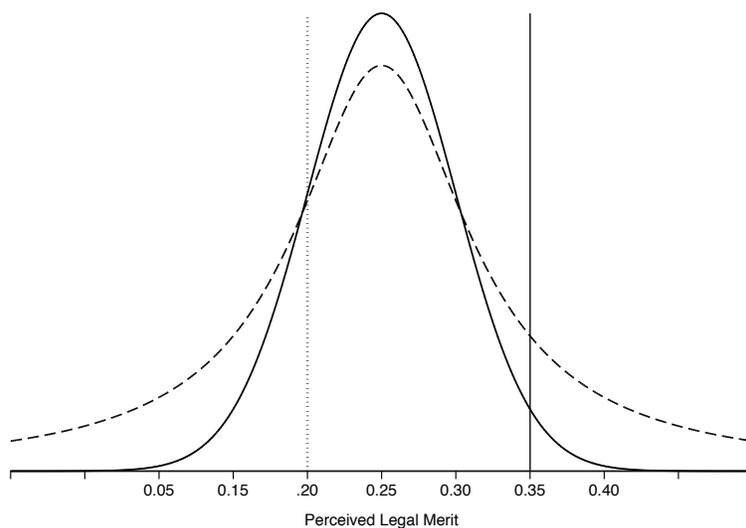
The necessary assumption is that not all breaches—either over direct or indirect expropriation—are challenged. In other words, actual selection must be taking place in both categories of claims for the reasoning to hold. Claimants must actually be weighing legal merit and deterrence benefits against costs of litigation, without one side of the scale dictating the filing decision. In the case of investment disputes, this seems a reasonable premise.

The expectation relies on “all else being equal”, and thus it is worth verifying that the two claim types are comparable in other respects. If the size of the award, for instance, differs in one claim type over another, then it might be that investors fight one type of claim, even at lower levels of legal merit, simply because the financial value of success is greater. This does not appear to be the case: looking at the data on damages, claims of indirect expropriation appear to be associated with slightly *lower* claimed damages on average, and slightly higher awards obtained; yet neither difference is statistically significant. The average amount claimed is USD\$1.6 billion for direct expropriation claims, and USD\$1.1 billion for indirect expropriation claims. These figures are skewed upward by two large outliers, but the difference remains insignificant if these are omitted. Similarly, there is no reason to think that litigation costs differ across the two categories. Direct and indirect expropriation claims are fought in much the same way, in the same arbitration venues.⁶⁶ To sum up the expectation, if indirect expropriation claims carry additional deterrent benefits from the firm’s standpoint, then conditional on being filed, they should be associated with lower odds of success.

One response might be that some claims are simply harder to litigate than others, perhaps because they pose a harder legal test. That is, some types of claims would be inherently more meritorious. As a result, a differences in success rates could be reducible to a measure of legal complexity. Yet this belief also requires that claimants themselves be ignorant about such variation. Indeed, if some claims were harder to litigate than others, these differences should be internalized in investors’ cost-benefit calculations when deciding whether to bring a case or not. That is, if one type of claim were “harder” to argue for any reason, investors should be less likely to bring it

⁶⁶Neither ICSID nor the Energy Charter, the two institutions that correspond to the greatest number of cases, are significantly more likely to see one type of claim versus the other.

Figure 2: Effects of Uncertainty of Outcome on Filing



in the first place. Variation in the average “difficulty” of claims should thus not affect theoretical expectations, unless we believe firms are unaware of it, which is unlikely.

A related belief might be that even if the average legal merit of a pool of cases remained constant, greater uncertainty over this legal merit might itself affect the selection of cases, and thus the success rate of those claims that are filed. The rules covering indirect expropriation, as described above, are less established than those related to direct expropriation. Even if investors had similar beliefs about the average expected chance of success, they may be less confident in the accuracy of those odds when it comes to indirect expropriation.

Figure 2 illustrates a hypothetical distribution of beliefs about the legal merit of cases for two types of claims. Both types exhibit the same average expectation of success, but one (indicated by the dashed line) reflects greater uncertainty about the odds of success. If investors file a case anytime it crosses a given merit threshold (indicated by the solid vertical line at 0.35), then more uncertainty over outcomes leads to a greater volume of cases, *even as* the average merit remains the same. Because the average merit is still the same, however, the pool of cases filed is necessarily weaker. As a result, conditional on being filed, cases taking on more ambiguous law would be less likely to succeed—owing strictly to a selection effect.

This reasoning rests on some restrictive assumptions. First, most potential cases must not get filed; that is, the required merit threshold must rest above the average merit of potential cases. If it is below (as indicated by the dotted vertical line in Figure 2), then the effect of legal ambiguity

would run in the opposite direction: ambiguity would be associated with fewer filings, and a higher average merit for these. Just as importantly, the required threshold would remain constant for all types of claims, irrespective of the level of uncertainty over their outcome. Yet it is likely that as uncertainty grows, investors would require higher perceived merit before filing. If risk aversion is sufficiently high, legal ambiguity could again be associated with a lower volume of filing. In other words, while there are plausible circumstances under which we might expect greater legal ambiguity, by itself, to result in a higher number of cases filed with lower merit, this effect is highly contingent.

What variation in uncertainty *cannot* explain is a trend through time: if anything, we would expect that ambiguity over indirect expropriation claims would decrease over time, as jurisprudence converges over its treatment of similar claims. This would, according to the reasoning above, decrease the volume of indirect expropriation claims filed, and increase their average legal merit. Yet as I show below, the trend we observe is the opposite, with the merit of claims decreasing precipitously through time, which should lead us to think that uncertainty is unlikely to be playing a dominant role.

To sum up, if investors choose to file indirect expropriation claims in part to deter regulation, they will require lower merit to file, all else equal, and we will see these claims lose with higher odds.

3.3.2 Expectations Over Settlement

Litigation is a costly and inefficient means of settling disagreements between parties.⁶⁷ As Robert Hudec, one of the seminal theorists of the trade regime, put it, “No functioning legal system can wait until then [the ruling] to exert its primary impact.”⁶⁸ The ISDS regime does not fare well by this metric, since the data show that more than 75% of cases reach the award stage, with the remainder either settled or discontinued. By comparison, less than 45% of cases produce a ruling in the trade regime.

Among investment claims, which would we expect to settle early? If firms file indirect expropriation claims in part to deter governments’ regulatory ambitions, then this has implications for the odds of early settlement: the deterrence objective would be advanced by dragging out litigation as much as possible. To refer back to the case of Philip Morris and Australia, five years elapsed between the filing of the claim, which made headlines worldwide, and the arbitrators’

⁶⁷Gilligan, Johns and Rosendorff 2010.

⁶⁸Hudec 1993, 360.

decision on jurisdiction (in favor of Australia). It would have taken at least one additional year, and likely more, if the arbitrators had reached a ruling on the merits. During this time, the firm benefits from any deterrent effect that its litigation may produce: in that case, New Zealand explicitly made it known that it would await the case's conclusion before continuing with its own plain packaging regulation.⁶⁹ Even past the ruling stage, of course, governments, especially those in developing countries, may be deterred from implementing regulation if they are sensitive to litigation costs or drops in FDI flows.⁷⁰ But during the period of litigation, the case is at its most salient. The result is that companies motivated in part by this deterrent effect should be less likely, all else equal, to settle early. The theory suggests that firms in these cases should be relatively less interested in compensation, and relatively more interested in the effects of litigation itself, compared to firms pursuing direct expropriation claims.

The incentives of governments combine to produce the same outcome—even if governments are aware of firms' incentives, and wary of the publicity that may accompany prolonged litigation. This is because of the prior expectation: if firms motivated in part by deterrence require a lower merit threshold to file, then governments will be faced with a pool of lower merit cases. They should be less likely to settle these. Indeed, in both domestic and international legal systems, settlements in the 'shadow of the law' usually represent a victory for the claimant or the plaintiff. In the case of the trade regime, scholars have shown that complainants obtain no fewer concessions from early settlements than following a favorable ruling.⁷¹ A similar pattern seems to emerge in investment disputes. Looking at the amounts of compensation obtained in settlements, these do not appear statistically different from the average amount awarded when the claimant wins the ruling.⁷²

In sum, we should expect indirect expropriation cases to be more likely to reach the ruling stage, and direct expropriation cases to be more likely to settle early. Firms will seek to drag out cases partly motivated by deterrence, and governments will be loathe to settle on cases of relatively lower legal merit.

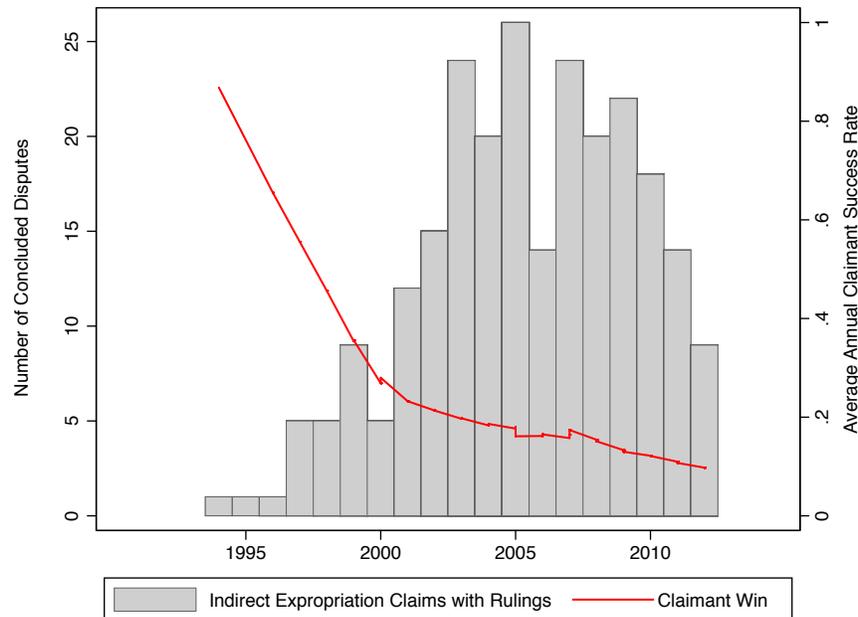
⁶⁹See *supra*, note 12.

⁷⁰Allee and Peinhardt 2011.

⁷¹Busch and Reinhardt 2000.

⁷²Average amount post-settlement is USD 495 million (based on 31 settlements with data on compensation amounts), compared to USD 524 million following a ruling. Once again, these amounts are skewed upward by a few outliers, but the difference remains statistically insignificant if we remove these outliers. Naturally, these descriptive figures do not account for selection.

Figure 3: Direct vs. Indirect Expropriation Claims in ISDS

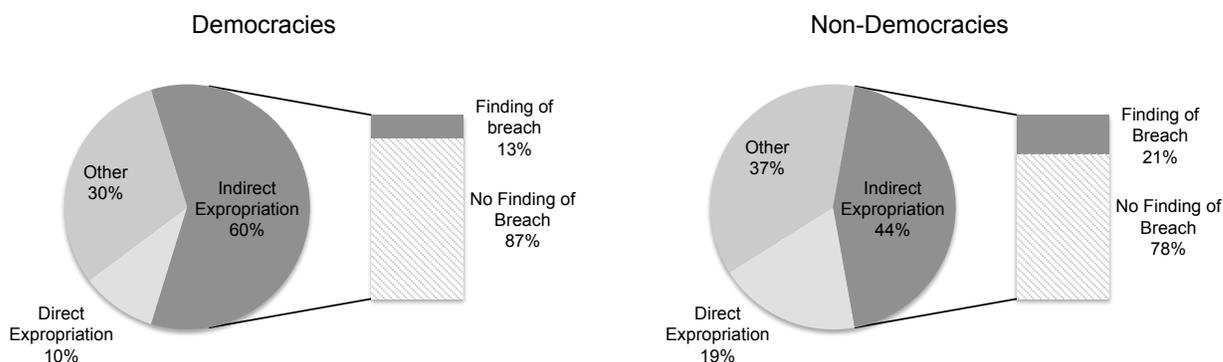


3.4 What Does the Record Show?

How does the record in ISDS vary across different types of claims, and does it correspond to the theoretical expectations? It is useful to begin by visualizing a couple of different aspects of this question. First, how does realized legal merit vary through time? Figure 3 illustrates the trend for indirect expropriation claims. The smoothed line shows the average annual success of indirect expropriation against a histogram showing the volume of concluded indirect expropriation cases. I purposefully align the cases shown in the histogram with those appearing on the legal merit curve. That is, the outcome recorded for a dispute in the histogram is shown in the same year, even if the ruling occurred three years later. As one might expect, the volume of concluded cases decreases in more recent years, even as the number of indirect expropriation claims filed continues to increase: these more recent cases have yet to produce a ruling. The downwards trend through time is statistically significant in both linear and non-linear estimations, for every 5-year span of the period under study. In sum, as the volume of litigation has increased, the rate of success of cases has declined precipitously.

Next, it is worth asking whether democracies are more prone to one type of claim than the other. If indirect expropriation claims are targeted at regulation, then we might expect that

Figure 4: Legal Claims and Success Rate By Regime Type



democracies would be more prone to such challenges. In fact, this is one recurrent criticism of ISDS in the policy debate. Figure 4 shows two pie charts. Democracies are defined as a Polity score of 7 or more, and non-democracies are those countries with a Polity score of less than 5. The difference is readily apparent: democracies face mostly indirect expropriation claims, while these constitute a minority of the claims brought against non-democracies. The opposite pattern pertains to direct expropriation claims, which make up nearly twice the proportion of litigation against non-democracies as they do against democracies. Further, one can quickly verify whether the rate of success differs by regime. Looking specifically at indirect expropriation, the answer is yes: democracies appear to lose 62% fewer indirect expropriation cases.⁷³

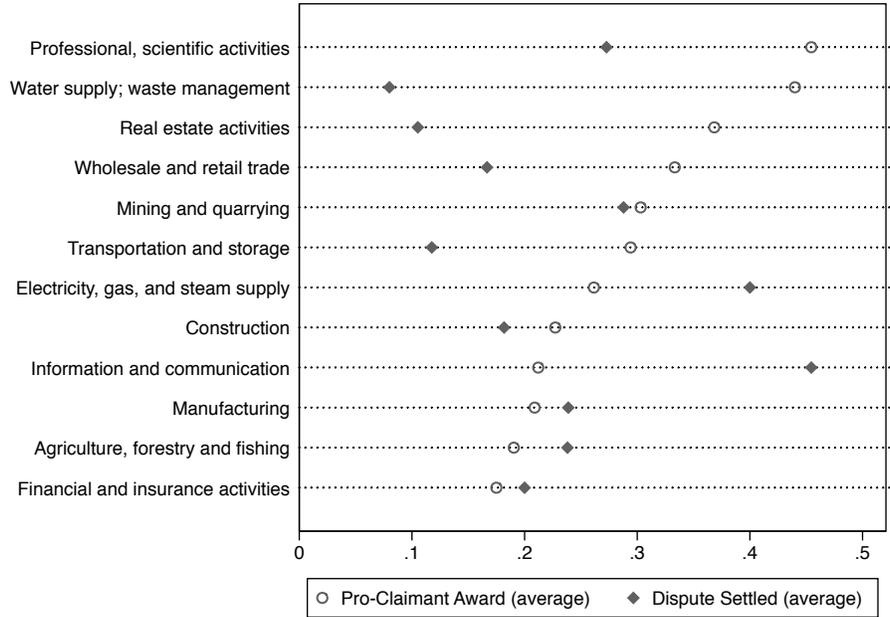
Much attention in studies of ISDS has been paid to the claimant’s industry.⁷⁴ For this reason, it is useful to look at variation in the rate of success of claims across different sectors. Figure 5 relies on the ISIC classification of the industry at issue in the dispute to chart the success rate across all industrial sectors that have seen a minimum of ten legal claims filed from 1993 to 2015. I also include the rate of settlement for comparison. While there is visible variation across industries, no obvious pattern emerges: using Wellhausen (2015) or Hafner-Burton et al. (2014)’s coding, neither mobile industries nor capital intensive ones are consistently associated with greater or lower rates of legal success or settlement.⁷⁵ Yet the variation across sectors is nonetheless sufficient that I explicitly take it into account in the analyses below.

⁷³This simple descriptive statistic does not control for wealth, which, as I show below, plays an important confounding role.

⁷⁴Wellhausen (2015) distinguishes industries by their degree of “mobility”, while in Hafner-Burton, Steinert-Threlkeld and Victor (2014), the capital intensity of the industry is what drives variation in transparency.

⁷⁵What is apparent, however, is that the latter two outcomes are inversely related, which is likely due to the fact that as more cases settle, a poorer pool of cases reaches the ruling stage.

Figure 5: Rates of Success Across Industrial Sectors



The mention of settlement brings us to the next important point. One of the article’s theoretical expectations is that if indirect expropriation claims have a deterrent function for firms, then they should be less likely to settle, and more likely to produce a ruling. If the objective is not merely to settle a disagreement, but also to temper regulatory ambitions, then litigation itself may be beneficial. The expectation over settlement also gains from being tested before the analysis of legal merit, since it gets at a type of selection that bears on that analysis: which claims are more likely to be settled will affect the pool of cases that make it to a ruling. Once again, a simple descriptive test allows us to provisionally reject the null hypothesis that settlement rates are the same across our two claim types of interest: the average rate of settlement for direct expropriation claims is 32%. The equivalent figure for indirect expropriation claims is a *third* of that, at just under 11%. Indirect expropriation claims are thus far more likely to go on to a ruling. This first concords with theoretical expectations over deterrence. But just as importantly, it dictates the type of estimation required for our main legal merit test. Any estimation of legal merit needs to account for the fact that a greater proportion of indirect expropriation claims are selected into the ruling stage.

To do so, I rely on a Heckman probit selection estimation. This model allows me to first estimate the odds of a case reaching the ruling, and then to use those estimates to correct for

selection in the outcome equation, which estimates the odds of a ruling in one direction or the other. To identify the model, one ideally needs a variable that affects the odds of a ruling, but that does not have an independent impact on the second stage outcome, the direction of the ruling. Theory provides us with a good candidate: a growing number of studies, looking especially at litigation in the trade regime, document how privacy increases the odds of settlement.⁷⁶ Specifically, settlement grows more likely when the stakes of a case can remain private. This insight can be readily applied here. One of the main dimensions of privacy in ISDS, which I further examine below, is whether the amount of compensation sought by the claimant is publicized. Displaying the “ask” in a bargaining game always makes it less likely that an agreement is reached—that is why interstate negotiations are invariably held in private. Yet whether the amount of compensation sought is made public or not is unlikely to have an independent bearing on the direction of the ruling. Indeed, when it is included in the second stage in the analysis below, it is insignificantly related to the ruling direction. In sum, it is an apt first-stage variable. I code the binary variable `AMOUNT SOUGHT PRIVATE` by looking at whether UNCTAD is able to arrive at this number.

The main explanatory variable of interest in both stages compares indirect expropriation claims to direct expropriation claims. I expect indirect expropriation claims to show higher odds of ruling, but lower odds of success for the claimant, conditional on a ruling. So that these variables refer to a common baseline, I code a variable, `OTHER LEGAL CLAIM`, to refer to cases that are neither direct nor indirect expropriation claims: these principally include National Treatment, MFN, and Arbitrary Discrimination claims. The result is that the `INDIRECT EXPROPRIATION CLAIM` is the exact opposite of a direct expropriation variable: the coefficient remains the same, only the sign changes. The only downside is that I lose the handful observations where both claims were filed. In the Appendix, I show how estimations that simply include a Indirect or Direct Expropriation indicator show the same results. Finally, I include a measure of the firm’s prior experience with arbitration, and the host government’s democracy level in the first stage equation, as these may shape preferences over the value of settlement.

In the second stage, the outcome variable is the direction of the tribunal ruling. Here I rely on UNCTAD’s own coding, which distinguishes between awards “decided in favor of the investor” and awards “decided in favor of the State”. I include only those disputes that have known outcomes, which leaves me with 425 cases (tellingly, the increase in the volume of litigation is such, that there are currently 223 cases that are pending across the various venues of the investment regime.) I also

⁷⁶Davey and Porges 1998; Porges 2003; Busch and Reinhardt 2006; Bown 2005.

control for a number of potentially confounding variables that might have an influence over the direction of the award. First among these is the wealth of the government. A number of studies have suggested that poorer countries lack the legal capacity to mount an effective defense against investment challenges. I use the log of GDP PER CAPITA, in constant 2005 dollars, obtained from the World Development Indicators. Along these lines, COUNTRY LEGAL EXPERIENCE controls for the number of ISDS challenges a country has handled in the past, to account for any learning effect, which has been identified in dispute settlement in the trade regime.⁷⁷ Because there is a prevalent belief that filing more claims in a case is a sign of low legal merit, CLAIMS NUMBER controls for the number of legal claims filed. The average is 2 claims, but some disputes include up to 7. I include a variable for DEMOCRACY, since democracies may face different incentives over investment disputes, and democracy may be another proxy for legal capacity. I account for the investment agreement underlying the dispute by including a dummy variable for the two agreements most frequently invoked, NAFTA and the ENERGY CHARTER, in case either of these sees higher odds of awards in a given direction. One fifth of disputes fall under one of these two agreements. Perhaps most importantly, I control for time, which I have already shown to be an important factor. We know that the legal merit of claims has been decreasing over the past two decades. The question is whether there is a difference in the success rate of different claims once we control for this catholic trend. I include Schoenberg splines at four knots in all estimations; using a simple year term instead produces the same results, but does not account for the non-linear effect of time. Because there may be some commonality of outcome within the industry of the claimant, as per Figure 5, I cluster the robust standard errors on the ISIC sector of the relevant investment.

The results are shown in Table 3. The first column estimates the odds of the firm winning the case, while the second column estimates the odds of the state winning the case—as the results demonstrate, these are not exact opposites: cases are not only settled, but they can also be discontinued, or decided in favor of neither party.

The findings are telling: indirect expropriation claims are significantly less likely to result in pro-claimant findings. When a case rests on an indirect expropriation claim, the odds of the claimant winning immediately drop by 51%, keeping all other variables at their mean values. In other words, indirect expropriation claims appear to be of significantly lower legal merit, all else equal, which is consistent with the belief that investors may derive some additional benefit from filing these cases.

⁷⁷Davis and Bermeo 2009.

Table 1: Legal Merit in the Investment Regime

	(1)	(2)
	Pro-Firm Ruling	Pro-State Ruling
Indirect Expropriation Claim	-0.98*** (0.25)	0.66*** (0.24)
Other Legal Claim	-0.60* (0.35)	0.16 (0.40)
GDP/cap (log)	-0.26*** (0.06)	0.18* (0.09)
Country Legal Experience	0.01 (0.01)	-0.02** (0.01)
NAFTA	-0.14 (0.17)	0.16 (0.24)
Energy Charter	0.14 (0.16)	0.05 (0.35)
Claims Number	0.06 (0.05)	0.02 (0.05)
Democracy	0.35* (0.18)	-0.34* (0.18)
Constant	-18.01 (16.20)	0.31 (17.78)
GOES TO RULING		
Amount Sought Private	-0.59*** (0.13)	-0.55*** (0.18)
Indirect Expropriation Claim	0.98*** (0.24)	0.98*** (0.24)
Other Legal Claim	0.11 (0.23)	0.11 (0.25)
Claimant Experience	-0.05 (0.11)	-0.08 (0.14)
Democracy	-0.09 (0.16)	-0.05 (0.16)
Constant	0.39 (0.28)	0.40 (0.31)
Time cubic splines	Yes	Yes
N	415	415

Heckman probit selection model with maximum likelihood (ML) estimates. First stage estimates likelihood of an award being rendered. Second stage estimates likelihood of a pro-claimant award (column 1) and a pro-state award (column 2). Robust standard errors clustered on the ISIC sector. * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

Across all estimations, richer countries fare better: the state wins more often, the wealthier it is. Controlling for wealth, democracy appears to have a tenuous negative effect on the odds of a state successfully warding off a legal challenge. This relationship between wealth and success is robust across both pro-firm and pro-state awards, and directly contradicts a recent claim in Franck (2014). There, relying on a smaller sample (159 disputes) and without accounting for selection, the author found that democracy wiped out the effect of wealth. This does not appear to be the case here. Interestingly, a country's legal experience with arbitration is not associated with higher odds of success. This is likely due at least in part to flurries of challenges against the same state arising from a similar context. For instance, Spain has recently been hit by over 20 disputes following the suspension of renewable energy projects in the midst of its recent fiscal crisis. When this happens, any learning effect is limited, and the state may face a number of losses, as Argentina did after its own crisis.

The selection model performs well: the Wald test for the first model shows a $\chi^2(1)$ of 16.98, suggesting that the null according to which the two equations are unrelated can be rejected at 0.0001 confidence level. In other words, accounting for selection is called for. Just as importantly, the key variable identifying the selection model behaves as expected: when the amount of compensation sought is made private, the odds of settlement is significantly increased. In fact, the odds of a ruling being produced increases by half when the amount sought by the claimant is kept private.

Consistent with the theory, indirect expropriation claims are far more likely to go to a ruling. In fact, a dispute is 52% more likely to result in the tribunal rendering a final award if it includes an indirect expropriation claim. The opposite is true for disputes that rest on a claim of direct expropriation: these appear significantly more likely to settle.

In sum, Table 3 provides support for two major theoretical expectations: (i) indirect expropriation claims are more likely to drag on and lead to a ruling, rather than to settle early. And (ii) conditional on proceeding to a ruling, indirect expropriation claims are far less likely to be ruled in favor of the claimant, and far more likely to be ruled in favor of the government.

The results are robust to a host of changes in the estimations. Including country wealth or experience at the first stage does not affect the findings for claim type at either stage. Secondly, as mentioned above, indirect expropriation claims are growingly filed alongside fair and equitable treatment claims. There is also some anecdotal evidence that this claim is sometimes included in the event that indirect expropriation claims fail. Might it be that those disputes that include both types of claim do better, by winning at least one of the two claims? I account for this

possibility by replacing the claim type by an indicator variable for disputes that include both indirect expropriation and fair and equitable treatment claims. The results remain the same: these disputes are significantly more likely to reach the ruling stage, and they are significantly less likely to be found in favor of the company filing them. Finally, while the Heckman selection model is called for on theoretical grounds, and supported by model diagnostics, it is worth noting that a single-stage probit model offers the same findings, both when the second stage equation is run by itself, and when all the first stage variables are added to the right-hand side. In all cases, indirect expropriation cases are still significantly more likely to be ruled in favor of the state, and less likely to be ruled in favor of firms.

3.5 Deterrence and the Incentives for Transparency

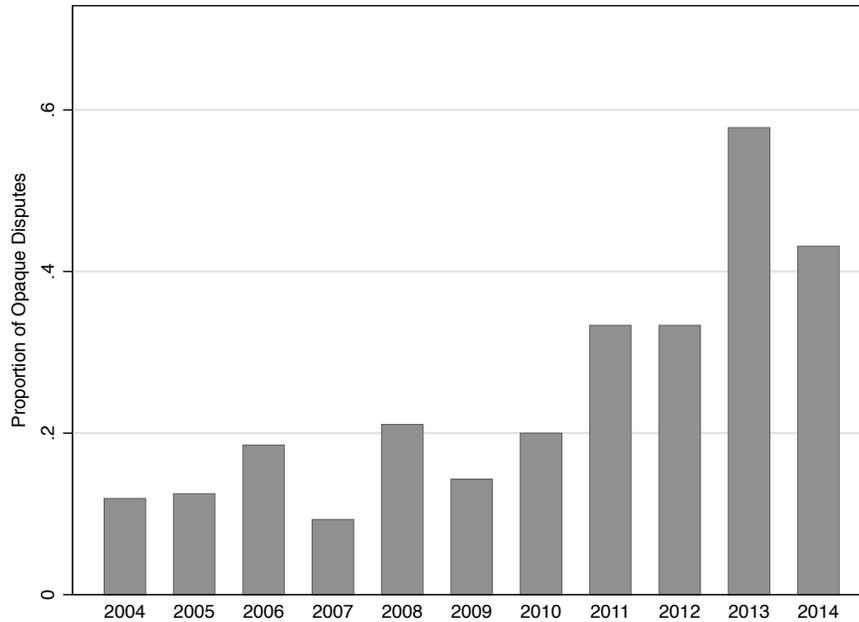
A final implication can be tested. If firms bring forth indirect expropriation claims not only to gain compensation, but also to temper regulatory ambitions by the respondent and other countries, then we would expect them to seek to publicize these disputes, rather than to hush them up. Conversely, when it comes to direct expropriation, where the main objective is to obtain compensation in the case at hand, firms would have no equivalent incentive for publicity, and may instead prefer to keep the matter private, to increase the odds of an agreement. From studies of other legal forums like the international trade regime, we know that privacy is conducive to settlement.

Do we observe the expected variation in transparency between the two claim types? Disputes vary in their level of transparency in a number of ways. Little can be said about the estimated 10% of all investment disputes that we lack any record of.⁷⁸ But the parties to a dispute can also decide to conceal various aspects of the case.⁷⁹ One key aspect of each dispute is the amount of compensation being sought. The amounts claimed in arbitration are often spectacular, and make for flashy headlines. Such headlines may be in the claimant's interest, if the objective is to scare off policymakers from enacting regulation, both in the claimant country and in other countries where the claimant may operate. Vattenfall, a Swedish multinational that generates energy in a number of countries, brought claims against Germany over its legislation to phase out nuclear power plants in the country. Vattenfall had every incentive to make this challenge salient, the better to deter German legislators, and other countries that might consider following suit, from phasing out nuclear power. It chose to publicize the amount of compensation sought, over USD\$ 5 billion. This spectacular figure made headlines worldwide, sending a clear message: banning nuclear power can

⁷⁸Schultz and Dupont (2014) estimate that 10% of the total universe of cases are such entirely opaque disputes.

⁷⁹Hafner-Burton, Steinert-Threlkeld and Victor 2014.

Figure 6: Opacity of Disputes in the Investment Regime



prove a costly goal. The point is that this signal is conveyed whether Vattenfall wins the case or not. If a claimant is hoping to deter governments, one of the best ways of doing so is to publicize the amount it is suing over. This one variable thus acts as an ideal proxy of transparency.

Looking at the data of investment disputes from 1987 to the present day, the amount of compensation sought is publicized in just under 70% of cases, and kept private in just over 30% of cases. But the true surprise is to look at the trend through time. While much is being made of the increased push for transparency within the ISDS regime,⁸⁰ the evidence belies such efforts. The fact is that over the last decade, the amount of transparency in the ISDS regime has been dropping steadily, a trend already identified by Hafner-Burton, Steinert-Threlkeld and Victor (2014) using a different measure. Figure 6 illustrates the proportion of claims where the amount of the award is hidden from the public. From an average of 11% in 2004, the proportion of opaque disputes, as proxied for by publicity of the award, rises to nearly to 60% in 2013. Several reforms, both at ICSID and UNCITRAL, have meant that *de jure* transparency has been increasing; but insofar as parties retain discretion over which aspects of a dispute to make confidential, they are increasingly using it to obscure. The result is decreasing *de facto* transparency.

Yet the variation that interests us is at the claim level: do disputes that bring indirect

⁸⁰de Mestral 2015.

expropriation claims show a different propensity to publicity than those that pursue direct expropriation claims? A quick look at the data suggest the preliminary answer is yes: 26% of direct expropriation claims keep the amount of compensation sought private, while only 14% of indirect expropriation claims do the same, and this difference is statistically significant.

Table 2: Opacity in the Investment Regime

	(1)	(2)	(3)
Indirect Expropriation Claim	-0.79*** (0.13)	-0.77*** (0.14)	-0.59*** (0.13)
Country Legal Experience		-0.00 (0.00)	0.00 (0.00)
Claimant Experience		-0.04 (0.07)	0.04 (0.07)
NAFTA		-1.51*** (0.41)	-1.66*** (0.41)
Energy Charter		0.15*** (0.05)	-0.01 (0.06)
Year	0.05*** (0.01)	0.04*** (0.01)	
Time cubic splines	No	No	Yes
N	659	659	659
r^2	0.11	0.14	0.18

Probit model with maximum likelihood (ML) estimates. The dependent variable is an indicator of whether a dispute keeps the amount of compensation sought in the dispute private. The constant is suppressed. Robust standard errors clustered on the ISIC sector. * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

Table 2 further demonstrates that this relationship holds when accounting for time, which Figure 6 showed to be such a significant driver of opacity. I use a probit model to estimate the odds of the compensation amount being kept private. I control for the legal experience of the company, since claimants may learn how privacy affects them as they gain experience in arbitration. As before, I control for disputes under both NAFTA and the Energy Charter. NAFTA, especially, is distinguished by high transparency requirements. I first include a simple year variable, since the upwards trend in opacity appears largely linear, but I also ensure that the results hold with cubic splines, in the third column.

The findings support the article’s last major expectation. Indirect expropriation claims are significantly less likely to be opaque: that is, claimants are more than twice as likely to publicize the size of compensation sought when they file an indirect expropriation claim, all else equal. To be exact, the odds of privacy are 41% for other claims, and only 15% for indirect expropriation

claims. This significant effect holds whether cubic splines, or a linear control for time are used. As might be expected, NAFTA disputes are far more likely to have the size of the award public than any other institution. Meanwhile, neither the claimant's nor the country's experience appears to have any effect on the opacity of disputes.

4 Conclusion

The investment regime has become the most controversial aspect of global governance. This article assesses the extent to which this controversy is warranted. First, I have been interested in whether the regime has undergone the fundamental shift identified by observers who claim there is a disjoint between the regime's original aim and its current application.

The shift is real, though it is largely of a *de facto*, rather than a *de jure* nature. The long-“dormant” issue of indirect expropriation has been permanently stirred up.⁸¹ The investor-state arbitration regime now considers mostly claims of indirect expropriation, rather than the type of “sovereign theft” represented by direct takings, and often envisioned by the literature. It targets mostly democracies, rather than rent-seeking regimes with poor rule of law. The current peculiar design of the regime, which awards financial compensation for regulatory breaches, further suggests the unintended nature of this shift. These are changes that the IPE literature studying investment has yet to fully come to terms with. As I argue, much of our theoretical apparatus is suited to a definition of expropriation that is now long out of sync with the reality of the regime.

Yet the paper's main findings are more nuanced. I examine whether the regime's most frequent type of legal challenge, claims over indirect expropriation, is prone to frivolous litigation. Because indirect expropriation most often targets regulation, investors filing these claims may derive a benefit from litigation no matter whether they win, if they are able to sway policy. I document a set of cases where the threat of costly litigation alone appears to have been enough to temper regulatory ambitions in a country—in Canada, New Zealand, Indonesia, Namibia. If these claims carry benefits other than financial compensation, then I argue that the process of case selection should lead us to expect that conditional on being filed, these cases should display lower legal merit, all else equal.

In trying to defend the legitimacy of the investor-state regime, policymakers often point out that investors fail to win most of the claims they bring.⁸² In this article, I suggest that this is

⁸¹Escarcena 2014.

⁸²See *supra*, fn. 7

precisely where the problem may lie. An international legal regime where litigation is both costly and generally unsuccessful fails at its primary function of bringing attention to treaty violations by sovereign states. The incentives it generates may be skewed, if claimants gain even when they bring weak cases. If the regime no longer identifies actual rent-seeking by governments, its informational function is jeopardized.

In aggregate, are indirect expropriation claims more prone to frivolous litigation? First, I show that the legal merit of cases has declined precipitously over time, and that this decline is concentrated in indirect expropriation cases. Investors have won only 21% of indirect expropriation disputes in the last decade. Contrast this to the trade regime, where the complainant rate of success hovers around 90%⁸³—precisely because states are so wary of filing a dispute against another country if they are unsure of its merit.

Secondly, indirect expropriation cases, which are more apt to generate positive spillovers for the investor by deterring regulation, are systematically less successful than other types of claims, such as direct expropriation cases. Third, indirect expropriation claims are 52% more likely to persist to the ruling stage, in a manner consistent with the belief that investors bringing such cases may be more interested in the benefits of litigation itself than in securing a favorable early settlement. By comparison, direct expropriation claims are far more likely to end in settlement, with no ruling rendered.

Fourth, I consider variation in transparency. Contrarily to the hopes of some, I show that the ISDS regime is growing *more* opaque with time. Yet in one subset of disputes—indirect expropriation claims—I argue that investors may actually gain from greater publicity if they seek to chill regulatory ambitions. This is exactly what we observe: indirect expropriation disputes are more than *twice* as likely to publicize the amount of compensation being sought by the investor in the dispute. In sum, evidence from settlement rates, ruling outcomes, and variation in transparency is consistent with a view that the most prevalent type of legal claim in the investment regime, over indirect expropriation, is prone to frivolous filings.

One final corollary finding bears mention. Wealthier countries do significantly better in litigation across the board. This would be an issue in any legal regime, but it is especially worrying in investment. Poor countries are most vulnerable to regulatory deterrence: they may be least willing to run the risk of costly litigation—even when the investor’s potential claim has little legal merit, as in the aforementioned case of Indonesia’s ban on open pit mining in protected forests⁸⁴—in

⁸³Leading some to ask “Why Does the Complainant Always Win at the WTO”? (Turk, 2011).

⁸⁴See *supra*, fn. 61.

order to push through public interest regulation. Another legal issue compounds this distributional concern: indirect expropriation claims often rely on investor “expectations” as a baseline against which to gauge whether there has been undue interference on the part of government.⁸⁵ Since developing countries on average feature weaker regulatory environments, they are more prone to such claims as a result,⁸⁶ since the regulatory baseline is lower. Taken together, these considerations suggest that concerns over distributional effects are well founded.

States are catching on to the trends outlined in this paper. In fact, governments’ attempts to revise existing agreements, and amend the design of new agreements, suggest the extent to which these changes were unanticipated. Miscalculation in international relations is rare; sustained miscalculation, repeated across hundreds of agreements, is rarer still. Yet all signs point to states having failed to foresee the development arc of this particular regime. The increase in volume of filings, together with the decrease in their legal merit, suggest a distortion of the intended system. The design of the regime, starting with private standing, has shaped investors’ incentives in such a way that it may pay to litigate even if the ruling is unlikely to be in their favor.

The US, arguably the world’s greatest proponent of investment rules, has revised its model BIT in reaction to its experience in NAFTA. Scholars point out that this change was precisely in reaction to the way in which “several [Chapter 11 claims were] perceived as ‘frivolous’ by the American government”.⁸⁷ The EU, whose member states, after all, invented the practice of ISDS, has also adapted its position on investor-state arbitration, and sought to decrease the risk of litigation challenging public interest regulation.⁸⁸ Its agreement with Canada, CETA, contains a provision allowing states to “file an objection that a claim is manifestly without legal merit”.⁸⁹ The TPP similarly tries to tilt control towards governments.⁹⁰ The findings in this article suggest that such changes, contained in agreements that have yet to be ratified, are beneficial. Judging by the widespread pushback against the regime, they may also come too late.

⁸⁵See Fortier and Drymer (2004). The sector of investment becomes relevant in these assessments: in sectors prone to fast moving environmental regulation, for instance, investors may have a higher hurdle if they argue that they could not have expected regulatory reform.

⁸⁶Gross 2002, 899.

⁸⁷Gagné and Morin 2006, 359.

⁸⁸See *supra*, fn. 7.

⁸⁹CETA Draft, Chapter 10, art X.29(1).

⁹⁰The Investment section of the TPP features the phrase “legitimate public welfare objectives” on no less than three occasions, each time in an attempt to distinguish between regulatory actions and indirect expropriation. Yet it falls short of providing an actual test to distinguish between the two.

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Table 3: APPENDIX: Legal Merit in the Investment Regime

	(1)	(2)	(3)	(4)
	(DV: Pro-Firm Award)		(DV: Pro-State Award)	
Indirect Expropriation Claim	-0.61*** (0.18)		0.55*** (0.20)	
Direct Expropriation Claim		0.68*** (0.22)		-0.56** (0.26)
GDP/cap (log)	-0.25*** (0.06)	-0.26*** (0.07)	0.19** (0.09)	0.19** (0.09)
Country Legal Experience	0.01 (0.01)	0.01 (0.01)	-0.02** (0.01)	-0.02** (0.01)
NAFTA	-0.20 (0.18)	-0.18 (0.17)	0.18 (0.24)	0.15 (0.26)
Energy Charter	0.18 (0.20)	0.19 (0.19)	0.00 (0.39)	0.00 (0.36)
Claims Number	0.10*** (0.04)	0.06 (0.04)	-0.00 (0.05)	0.06* (0.04)
Democracy	0.24 (0.17)	0.32** (0.15)	-0.31* (0.17)	-0.33** (0.15)
Constant	-13.09 (14.16)	-11.86 (15.39)	-2.14 (17.91)	-0.99 (17.68)
GOES TO RULING				
Amount Sought Private	-0.61*** (0.12)	-0.74*** (0.16)	-0.57*** (0.18)	-0.76*** (0.18)
Indirect Expropriation Claim	0.89*** (0.16)		0.90*** (0.16)	
Direct Expropriation Claim		-0.42* (0.24)		-0.44* (0.25)
Claimant Experience	-0.07 (0.12)	-0.15 (0.13)	-0.08 (0.15)	-0.18 (0.17)
Constant	0.45** (0.21)	1.08*** (0.25)	0.45* (0.24)	1.12*** (0.29)
Time cubic splines	Yes	Yes	Yes	Yes
N	425	425	425	425

Heckman probit selection model with maximum likelihood (ML) estimates. First stage estimates likelihood of an award being rendered. Second stage estimates likelihood of a pro-claimant award (columns 1-2) and a pro-state award (columns 3-4). Robust standard errors clustered on the ISIC sector. * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$