The Achilles' Heel Of Investor-State Arbitration Awards

By Kenneth Reisenfeld and Joshua Robbins, Baker & Hostetler LLP

Law360, New York (December 6, 2016, 3:51 PM EST) --
Cost awards in investor-state arbitration have become a significant component of a case’s disposition, but the standards applied, quantum and percentage allocation are often difficult to predict. As the size and complexity of investment treaty claims have grown, the costs of prosecuting and defending these claims, including counsel fees, arbitrator fees, expert witness fees, and administrative charges, are often measured in millions — or even tens of millions — of dollars or euros. In February 2016, a study by litigation funder Vannin Capital found that the parties’ average combined cost of litigating an ICSID case, excluding arbitrator fees, now exceeds $10.5 million, with the median cost at around $6.5 million.

Parties are understandably keen to be able to predict whether they or their opponents are likely to bear most or all of these costs. Interest is particularly acute among third-party funders (such as litigation finance companies) and insurance companies which often offer coverage for the risk of an adverse cost award.

Unfortunately for litigants, funders and insurers alike, investor-state tribunals have tended to place scant focus on the cost allocation analysis of their awards, often providing only minimal explanation for decisions that may shift millions of dollars of exposure to a losing party, its funders or insurers. Without formal guidelines from the arbitral institutions or clear patterns emerging from the case law, predictability — essential for all parties, including those considering the commencement of new cases — remains elusive.

The July 8, 2016, merits decision in Philip Morris v. Uruguay is a classic example of the problem. Philip Morris was a relatively novel case, raising significant and unprecedented questions of international intellectual property rights and sovereign authority to regulate public health. It also was a very expensive case, lasting over six years, involving some 43 attorneys and 17 expert witnesses, and costing the parties over $27 million in legal fees and expenses alone. Ultimately, the tribunal ordered the claimant to bear nearly all of the costs, even though it had won the jurisdictional phase of the case and the arbitrators reached a split decision on the merits. The reasoning for this costs award was spare, and illustrates a common Achilles’ heel in investor-state awards: the tribunal paid short shrift to the standards applied and the factual and legal bases for its cost allocation determination.
Rules and General Practices

Cost allocation is left largely to a tribunal’s discretion, and there is little black letter law to guide the decision. While Article 61(2) of the ICSID Convention and ICSID Arbitration Rule 47 grant tribunals the power to decide how costs of the arbitration are allocated among the parties, neither provide standards for the exercise of this exercise of discretion. Article 42.1 of the 2013 UNCITRAL Arbitration Rules provides that the losing party should ordinarily pay costs, although the tribunal may decide otherwise based on “the circumstances of the case.”

Traditionally, tribunals in international commercial arbitration have applied the “English rule” or “loser pays” approach, in which the “costs follow the event.” This approach is designed to make the winning party whole and to discourage frivolous claims or defenses. Investor-state tribunals, historically, have adopted the “American rule” or “pay as you go” approach, in which each party is expected to pay its own legal expenses as well as its split of the arbitrator costs and administrative fees.

Recently, some investor-state tribunals have begun to adopt a modified version of the “loser pays” rule, in which a portion, but not all, of the costs are shifted to the losing party. The amount shifted often turns on several factors, including: (1) which party succeeded on specific jurisdiction or merits issues at different stages of the case; (2) whether the case presented novel, complex or particularly close or difficult issues; and (3) whether the parties had conducted the litigation in a responsible manner. In a number of these recent cases, however, tribunals have not provided a sufficiently clear explanation for their costs decision.

Philip Morris — Jurisdiction and Merits

The claims in Philip Morris challenged two measures the Uruguay government had enacted in an attempt to discourage smoking: one required cigarette packages to be covered in anti-smoking warnings and another barred a company from marketing more than one type of cigarette per brand. Philip Morris argued that these measures expropriated its trademarks and denied it fair and equitable treatment, among other claims. It also complained that the Uruguayan courts had committed a denial of justice by reaching inconsistent rulings regarding these anti-smoking measures and failing to address the company’s arguments.

Uruguay raised various jurisdictional challenges, which were addressed in a separate, bifurcated phase of the case, and which involved two rounds of briefing, expert witness reports, and an oral hearing. The tribunal unanimously rejected each of these jurisdictional objections and the case proceeded to a merits phase.

In the merits award, a majority of the tribunal sided with respondent Uruguay. On the expropriation claim, the tribunal issued a sweeping and somewhat novel ruling that the anti-smoking measures were not compensable because they involved an exercise of Uruguay’s sovereign “police power” to protect public health. As to fair and equitable treatment, the majority of the tribunal relied on amicus curae submissions from two international organizations, as well as European Court of Human Rights jurisprudence, in determining that the challenged measures were reasonable. Regarding denial of justice, the majority found that the courts’ actions were flawed but consistent with due process. As noted below, one arbitrator dissented as to the holdings on fair and equitable treatment and denial of benefits.
At eight paragraphs out of an award that exceeded 76 pages (not including the 45-page dissent), the tribunal's analysis of costs is a study in brevity. Philip Morris's costs were about $17 million, Uruguay's slightly over $10 million, and the arbitration and administrative fees totaled $1.5 million. The tribunal ultimately opted for a “loser pays” approach, requiring Philip Morris to cover the vast majority — $7 million — of Uruguay’s expenses, and all $1.5 million of the arbitration costs, for a total cost allocation award of $8.5 million, on top of Philip Morris own costs of $17 million that had already been spent to pursue the arbitration.

Despite the magnitude of this cost award, the tribunal provided little explanation of its bases. The tribunal cited in passing “the significant disproportion between the Parties’ respective costs,” the fact that the total costs exceeded the amount Philip Morris had sought in the arbitration ($22 million plus interest), and the fact that Philip Morris’s merits claims had been “substantially rejected.” “On balance,” the tribunal concluded, “the outcome of the case has favored the Respondent to a large extent.” Thus, the tribunal said, it was “fair and reasonable” for Philip Morris to bear the bulk of the costs.

That seems a fairly slender reed on which to rest a multimillion dollar cost-shifting decision, particularly when countervailing factors are considered. First, as discussed earlier, the length and cost of the dispute were increased substantially because Uruguay had challenged jurisdiction on multiple grounds and requested a bifurcated procedure, which it lost. Although the tribunal did not make a final assessment as to the costs arising from the preliminary phase of the case, that it extended for approximately two years — the same length as the merits phase — suggests that the unsuccessful jurisdictional objections were at least a major contributor to the expense of the overall case. The tribunal unanimously had rejected Uruguay’s jurisdiction challenges in their entirety. It is thus a fair question as to whether these costs and this result were — or should have been — expressly taken into account in allocating the costs of the overall arbitration so heavily against the claimant. In particular, one wonders whether Philip Morris ultimately was forced to pay at least some portion of Uruguay’s costs and the tribunal’s fees for Uruguay’s losing jurisdictional challenges, even though Philip Morris was the clear victor of this preliminary phase. This basic question remains unanswered, as the final award does not say.

Second, the costs were multiplied further by the intervention of third parties seeking to file amicus submissions on behalf of Uruguay, including the World Health Organization and the Pan-American Health Organization. Philip Morris neither caused nor promoted those filings, and the disputing parties litigated their admissibility, which added to the cost of the dispute. Yet the award does not appear to make any deduction for these added expenses.

Third, as the tribunal acknowledged, the case had “given rise to important and complex legal issues” and both parties had “raised weighty arguments.” Its decision on expropriation delved into complex domestic and international property law issues, relied heavily on the amicus submissions, and invoked a somewhat novel “police powers” doctrine granting special latitude for public health measures. Moreover, the tribunal’s holdings as to fair and equitable treatment and denial of justice were not unanimous. Arbitrator Gary Born issued a 45-page partial dissenting opinion, finding for Philip Morris on these two issues and questioning the majority’s “unusual” decision to import a principle from decisions of the European Court of Human Rights (“margin of appreciation”) into the investment treaty context, something prior tribunals had rejected. Even the majority admitted that as to the denial of justice claim, “there is clearly a case to answer here,” based on “procedural improprieties” or “irregularities” in the Uruguay courts’ actions.
Fourth, the tribunal’s reference to the parties’ disproportionate expenditures was puzzling. It was to be expected that Philip Morris would incur larger legal bills, as it bore the burden of proof. And it makes little sense to suggest that a party’s own expenses should determine how much of the other party’s expenses it should bear. Nor did the tribunal explain why the fact that the parties’ combined costs exceeded the amount claimed should be held against the claimant. Philip Morris had no control over Uruguay’s expenditures, had opposed bifurcation of the case and, in any event, had an obvious built-in incentive not to overspend on its own account. Moreover, to penalize a party for spending heavily on its legal representation (perhaps by retaining expensive counsel or experts) may raise due process issues.

It is possible that there was an unspoken rationale. The case was a controversial one, and some (including Uruguay’s counsel) accused Philip Morris of using the arbitration process, and the expense it entailed, as a way to discourage relatively poor countries (not limited to Uruguay) from enacting anti-tobacco measures. The tribunal may have shifted costs to Philip Morris in part to send a message both to companies considering adopting such a strategy and to critics who pointed to the case as an example of the abuses of investor-state dispute settlement. But whether justified or not, if that was the tribunal’s justification, it would have been better to say so. Article 48 of the ICSID Convention, after all, requires that an award state the reasons on which it is based, and Article 52(1)(e) permits annulment when a tribunal fails to do so.

Implications

Philip Morris highlights several trends in investor-state cost decisions. First, and most glaringly, the amounts at stake are becoming significant by any measure. Second, tribunals increasingly are willing to shift costs to a losing party, even in cases involving a split decision on liability. Two other 2016 decisions — in Mesa Power v. Canada and İçkale İnşaat v. Turkmenistan — further illustrate this point. Third, tribunals appear ready to stick the loser on the merits with the burden of paying costs even for a jurisdictional phase that it had won. And perhaps most problematic for practitioners, parties and future panels, tribunals continue to pay relatively little attention to explaining the reasoning behind their cost awards, making it difficult to develop a consistent jurisprudence on the issue and impeding a party’s ability to assess the full risks of proceeding with an investor-state dispute.

Kenneth B. Reisenfeld is a partner and Joshua M. Robbins is a counsel in the international arbitration and litigation practice of Baker & Hostetler LLP. Both are based in the firm’s Washington, D.C., office.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

All Content © 2003-2016, Portfolio Media, Inc.