TPP in Focus: Investment and Investor-State Dispute Settlement – The Need for Reform

MAR 20, 2015 Issues: Trans-Pacific Partnership

Investment chapters in U.S. free trade agreements (FTAs), in particular the dispute settlement mechanism known as "investor-state dispute settlement" (ISDS), have received heightened scrutiny from a broad-range of interested parties. While investment provisions have a long history and respond to unfair actions against investors, the changing scope and nature of globalization require a careful re-examination of ISDS provisions. It is clear that if we are going to maintain provisions that seek to protect U.S. investment abroad we must further reform the ISDS chapter in TPP to ensure that governments preserve the ability to regulate in the public interest.

Countries began negotiating investment agreements back in the 1950s, and the United States began in the 1980s, to provide investors with some basic rights abroad and a method to resolve disputes. Concerns then arose in the United States after some troubling decisions by NAFTA tribunals in the 1990s and early 2000s. In response, the text of U.S. investment agreements was substantially modified in 2002 through 2004 to address those concerns. But since then, the number of ISDS disputes has risen substantially and the kinds of claims have changed as well. A number of Members of Congress, stakeholders, and academics are concerned about these developments and the possibility that ISDS could be used to undermine legitimate public interest laws and regulations.

There are a number of proposals circulating to protect the rights of sovereign nations in the TPP, including: (1) a clarification of the so-called "minimum standard of treatment” obligation; (2) the inclusion of a mechanism for the TPP countries to agree that a claim submitted by an investor should be dismissed; (3) a statement in the text of the agreement that the investment obligations in TPP are not intended to accord greater substantive rights than domestic investors have under domestic law where, as in the United States, protections of investor rights under domestic law equal or exceed those set forth in the TPP Agreement; and (4) a recognition of the right of governments to restrict the cross-border transfers of funds where necessary to prevent or mitigate a financial crisis. Others have proposed other reforms that deserve consideration as well.

This blog reviews the history of the investment provisions, explains the continued need for reform, and provides a more detail explanation regarding the proposals mentioned above.

I. Early Rationale for Initial Investment Protections

There is a history of countries discriminating against foreign individuals and companies. For instance, companies have had their facilities taken over by foreign governments without receiving any compensation and have faced discriminatory treatment simply because of their nationality.

To address these abuses, the United States has negotiated bilateral investment treaties (BITs) with 47 countries and FTA investment chapters with 20 countries to date. The United States concluded its first BIT in 1982, largely modeled on European BITs that had been in place since the 1950s. Today, there are over 2,000 BITs in effect worldwide, and there are numerous bilateral or regional trade agreements that include similar investment chapters.

U.S. BITs and FTA investment chapters generally have contained the following provisions:

- Non-Discriminatory Treatment. A party is required to treat investors of another party "no less favorably" than the host country's own investors or investors from third-countries;

- Expropriation. A party is required to compensate the investor of another party when a government expropriates an investment;

- "Minimum Standard of Treatment" (MST). A party is required to provide a minimum standard of treatment, consistent with customary international law, including "fair and equitable treatment" and "full protection and security" for investors; and

- Investor-State Dispute Settlement (ISDS). An investor has the right to submit an alleged breach of the investment provisions to international arbitration. ISDS was designed to depoliticize these disputes and provide a neutral forum to resolve unfair treatment abroad to U.S. investors.

II. Early Concerns Over NAFTA Investor-State Cases

The North American Free Trade Agreement (NAFTA) was the first U.S. trade agreement to include an investment chapter and ISDS. While many of those cases did not involve the United States (and the US Government has never lost an investment dispute), some of the legal reasoning and outcomes in the early NAFTA cases were troubling.

For example, in *Metalclad vs. Mexico*, a U.S. company purchased a hazardous waste landfill in Mexico and was issued permits to operate the landfill from federal and state authorities. The municipal government in Mexico later denied Metalclad a construction permit based on concerns regarding the environmental impact of the project. The NAFTA tribunal found that the municipality breached the MST obligation in NAFTA by denying a construction permit for environmental reasons (rather than for things like physical construction defects) and faulted Mexico for not ensuring a "transparent" investment environment.

While the MST obligation was intended to be based on customary international law (i.e., a legal obligation derived from a general and consistent practice of states followed by them from a sense of legal obligation), the tribunal did not examine customary international law in its decision. The tribunal also found that these and other government actions constituted an indirect expropriation of the investor's investment, noting that expropriation includes "incidental interference with the use of property which has the effect of depriving the owner, in whole or significant part, of the use or reasonably-to be-expected economic benefit of property even if not necessarily to the obvious benefit of the host state."

III. U.S. Negotiators Respond

In 2004, Congressional Democrats worked with USTR and the State Department to develop a new model that contained several changes to address these issues, including the following:

- <u>Indirect Expropriation.</u> The post-2004 texts include an expropriation annex that:
    - restates the three key factors in the seminal U.S. Supreme Court's Penn Central decision

pertaining to “regulatory takings” under U.S. constitutional law;

- clarifies that “the fact that an action...has an adverse effect on the economic value of an investment, standing alone, does not establish that an indirect expropriation has occurred” (responding to criticisms of the Metalclad decision); and

- includes a statement that, “[e]xcept in rare circumstances, nondiscriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations.”

- <u>Minimum Standard of Treatment.</u> The texts clarified that parties are only obligated to provide treatment “in accordance with customary international law, including fair and equitable treatment and full protection and security.” These concepts “do not require treatment in addition to or beyond that which is required by that [customary international law] standard, and do not create additional substantive rights.”

- <u>Eliminating Frivolous Claims.</u> The texts require arbitrators to “decide as a preliminary question any objection by the respondent [government] that, as a matter of law, a claim submitted is not a claim for which an award in favor of the claimant may be made.” A respondent government may be entitled to recoup reasonable costs and attorney’s fees if the claim was frivolous.

- <u>Transparency and Public Participation in Arbitral</u>

> Proceedings. The texts require that key documents be made publicly available and provide that the tribunal has the authority to accept amicus curiae ("friend of the court") submissions from any person or entity that is not a disputing party.

In addition, in 2007, House Democrats included in the May 10th Agreement a provision to further clarify the limits of the investment obligations. The following provision was added to the preamble of FTAs with Colombia, Panama, Peru, and South Korea:

> [F]oreign investors are not hereby accorded greater substantive rights with respect to investment protections than domestic investors under domestic law where, as in the United States, protections of investor rights under domestic law equal or exceed those set forth in this Agreement.

The United States unveiled a new model BIT in 2012 although disappointingly the 2012 model BIT did not include the May 10th preambular language.

IV. Continuing Concerns & the Recent, Further Proliferation of ISDS Cases

Some TPP parties do not support ISDS or are seeking safeguards to ensure that nations preserve their right to regulate. The Economist magazine, the Cato Institute, the European Union, and the German Government have also expressed concerns. The Administration responded to concerns raised recently by Senator Elizabeth Warren, which prompted this reply from the Cato Institute.

The number of disputes has proliferated in recent years, involving increasingly novel and costly challenges to public welfare and environmental regulations, and may have a chilling effect on government actions. For example, Philip Morris recently sued Australia under a Hong Kong-Australia BIT, arguing that cigarette warning labels interfere with its trademarks and constitute an indirect expropriation of its investment.

In a June 2013 paper, the UN Conference on Trade and Development (UNCTAD) noted concerns with ISDS relating to "a perceived deficit of legitimacy and transparency; contradictions between arbitral awards; difficulties in correcting erroneous arbitral decisions; questions about the independence and impartiality of arbitrators, and concerns relating to the costs and time of arbitral procedures." UNCTAD also noted a proliferation of ISDS cases, setting a new record in 2012, as the following chart demonstrates:

Source: UNCTAD

Importantly, most of these cases do not involve U.S. investment agreements, and U.S. investment agreements include many safeguards for government actions that are not found in other agreements. For example, UNCTAD recently listed a number of 'procedural innovations,' all of which have already been included in U.S. agreements: setting a time limit for bringing claims; giving governments a mechanism to interpret existing agreements; allowing the consolidation of claims; enhanced transparency; and removing frivolous claims.

Nevertheless, some recent cases under U.S. agreements are not the kind of cases envisioned when ISDS was first established. For example, Eli Lilly recently sued Canada, arguing that Canada's patentability criteria on medicines violate the investment protections in NAFTA.

There are also still concerns regarding the manner in which tribunals interpret U.S. investment agreements. For instance, tribunals have continued to construe the MST obligation in a broad fashion. Scholars have commented on this continued practice:

> [I]nvestment tribunals continue to construe even [customary international law]-based [minimum standard of treatment] provisions to impose broad limits on government authority by accepting, without any evidence of state practice or opinio juris, the pronouncements of previous tribunals as definitive evidence of the standard under [customary international law].

Take, for example, *Railroad Development Corporation (RDC) vs. Guatemala*, a case brought by a U.S. company under the Central American Free Trade Agreement (CAFTA), which included the improvements made to the investment text in the 2004 Model BIT. The tribunal neglected to base its interpretation of the MST obligation on customary international law, instead relying on a previous tribunal's decision in a NAFTA case. Decisions like these suggest that tribunals require even further guidance on what the MST obligation actually means.

V. Necessary Investment and ISDS Reforms

The investment chapter of TPP still needs to undergo further procedural and substantive reforms. The status quo is clearly not satisfactory, especially given the expanding scope of globalization and the clash of interests. Nearly every provision listed by USTR as an improvement for TPP (e.g., enhanced transparency, allowing amicus briefs, removal of frivolous claims, etc.) have been included in past U.S. FTAs for more than a decade. In response to the changing dynamic, USTR has indicated that the TPP "will make absolutely clear that governments can regulate in the public interest" – which would be new. However, that will not be meaningful unless incorporated into specific reforms, and careful attention must be paid to the exact language in any "public interest" provision to ensure that it achieves the goal.

The following are additional reforms that would improve the TPP investment chapter.

i. *Clarification of the Minimum Standard of Treatment*

Investors have argued for more extensive protections under the MST obligation than customary international law provides. For instance, the investor in *Glamis Gold vs. United States* argued that the MST obligation requires a government to compensate a foreign investor who has been harmed by merely "arbitrary" government action. The Glamis Gold tribunal was not persuaded by this argument and its decision accurately described how customary international law limits a tribunal's interpretation of the MST obligation. This description was fully consistent with the arguments the US Government made in that case.

Consistent with the decision in *Glamis Gold*, the TPP investment chapter should make clear that: (1) the investor bears the burden of proving that an obligation exists under customary international law; and (2) the MST obligation only protects investors against "egregious" or "outrageous" conduct (the so-called *Neer* standard). In the *Neer* case (1926), the U.S.-Mexico Claim Commission expressed the concept as follows: "the propriety of governmental acts should be put to the test of international standards...the treatment of an alien, in order to constitute an international delinquency should amount to an outrage, to bad faith, to wilful neglect of duty, or to an insufficiency of government action so far short of international standards that every reasonable and impartial man would readily recognize its insufficiency." This 'minimum standard' best ensures a balance between respect for the sovereignty of nations and the need to protect investors in extreme cases.

ii. A Workable Diplomatic Screening Mechanism

U.S. BITs and FTAs already include a mechanism that allows the two governments to adopt an interpretation of an investment obligation that is binding on an ISDS tribunal. Further, U.S. FTAs have included a diplomatic screening mechanism of sorts, but only for tax measures. This mechanism should be extended more broadly so that it covers other public interest issues, such as environmental and public health measures.

Specifically, the two governments (the government of the claimant/investor and the government respondent in an ISDS case) could agree that a particular claim is not a claim for which an award in favor of the claimant may be granted. In other words, a dispute would not be subject to ISDS if both governments agree that a claim should be dismissed.

iii. ***May 10th Preambular Language***

As noted above, the May 10th Agreement contained a provision to be included in the preamble to U.S. FTAs asserting that the agreement does not provide foreign investors with greater substantive rights than U.S. domestic investors. Preambular language such as this can serve as a useful interpretive guide to a tribunal in analyzing investment claims.

Some have argued that other countries will not accept a provision that only references U.S. law (and not the domestic law of other countries). However, a number of foreign countries have already agreed to this language. It was included in the Colombia, Panama, Peru, and Korea FTAs. TPP should also include this language.

iv. *Restrictions on Capital Flows to Prevent and Mitigate Financial Crises*

U.S. investment chapters currently provide that each Party shall permit “all transfers relating to a covered investment to be made freely and without delay into and out of its territory.” Such transfers include “contributions of capital,” “profits,” and “payments made under a contract.” There is a longstanding debate as to whether an exception to this obligation should be made to prevent and mitigate financial crises. The WTO General Agreement on Trade in Services (GATS), the IMF Articles of Agreement, and the OECD’s Capital Movements Code each address this issue. However, U.S. negotiators continue to resist including such exceptions in U.S. trade agreements. The Korea and Chile FTAs explicitly address the issue, but each provides an exception in fairly limited circumstances.

Recently, more than 250 economists, including Birdsall, Rodrik, and Stiglitz, has urged “that future U.S. FTAs and BITs permit governments to deploy capital controls without being subject to investor claims[.]”

Other TPP countries have insisted on such an exception. The focus is now on ensuring that the language in the exception is neither too narrow nor too broad.

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