Flaws in the European Commission's proposals for foreign investor protection in the Transatlantic Trade and Investment Partnership

Gus Van Harten, Osgoode Hall Law School

In November 2015, the European Commission released a proposed text on foreign investor protection in the EU-US Transatlantic Trade and Investment Partnership (TTIP).[1] The EC's proposal has various flaws arising from concerns about the foreign investor protection system in general and from detailed aspects of the proposed text. In particular, the flaws undermine the EC's claims that it has fixed investor-state dispute settlement (ISDS) and safeguarded the right to regulate. They also highlight weaknesses in the EC's proposals for foreign investor protection in agreements like the TTIP. This policy brief outlines six key flaws.

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1. The case still has not been made for foreign investor protection in the TTIP

The foreign investor protection system gives a special status and, in effect, a public subsidy to foreign investors faced with the usual risks of democracy and regulation. In the case of the TTIP, the EC is proposing to expand this system to countries whose courts are reliable, accessible, independent, and much superior to ISDS itself.

Various assertions have been made to justify the expansion of ISDS in this context. Yet they are never, in my experience, accompanied by any real evidence to show that European or U.S. courts have systemic failings to justify giving such an extraordinary international status and public subsidy to foreign investors.

For example, the EC has said that ISDS is needed to protect small and medium enterprises (SMEs). However, the EC does not provide evidence of actual benefits of ISDS for SMEs nor does it address the extensive evidence of the significant costs. As an illustration of the latter, small companies have recovered only a tiny fraction of the total compensation ordered by ISDS tribunals and, for the vast majority of small companies that have brought ISDS claims, the legal and arbitration costs of doing so appear to have exceeded any compensation ordered.[1] Moreover, domestic investors and citizens have no right to protection in ISDS, while ISDS can be used to pressure governments to appease large multinationals and very wealthy foreigners. In short, ISDS skews decision-making and the market in favour of bigger foreign players at the expense of smaller and domestic ones.

Any proposal to give special privileges or subsidies to any economic actor – here, the largest and wealthiest in the world – calls for a strong justification based on clear evidence of the public benefit. The absence of such a justification and evidence has been a glaring omission in the EC's proposals for foreign investor protection from the start.[2]

2. The EC's proposals are fundamentally imbalanced

The EC is proposing exceptionally powerful rights and protections, without any actionable responsibilities, for foreign investors.[3] Again, the EC gives no serious justification for this discrimination in favour of foreign investors over domestic investors and citizens.

If the EC was committed to balance, it would ensure at least that ISDS could be used to hold foreign investors to account if they flaunted labour, environmental, consumer, or other standards in

[1] G Van Harten and P Malysheuski, "Who Has Benefited Financially from Investment Treaty Arbitration? An Evaluation of the Size and Wealth of Claimants", Osgoode Legal Studies Research Paper No. 14/ 2016, prepared in collaboration with the University of Oslo's PluriCourts project, online: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2713876. In the EC's proposal, the minor changes to ISDS for SMEs do little to address the core issues that the disputed amounts at stake for SMEs would rarely justify the cost of bringing an ISDS claim, that the relative availability of ISDS for large multinationals puts SMEs and domestic investors at a competitive disadvantage, and that the financial dependence of ISDS arbitrators (and ICS "judges") on future claimants works in favour of large multinationals that are more likely to be repeat players in ISDS. If the EC wanted to protect SMEs from mistreatment abroad, there are better options than ISDS. For example, the EC could establish an SME political risk insurance program that shifted funds from paying ISDS lawyers and arbitrators to actually compensating SMEs.

[2] G Van Harten, "Comments on the European Commission's Approach to Investor-State Arbitration in TTIP and CETA", Osgoode Legal Studies Research Paper No 59/2014 (3 July 2014), online: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2466688.

[3] Ibid.

situations where domestic or European institutions do not offer an effective remedy.[4] The EC's proposal takes no steps at all toward such a balance.

The way forward on this specific issue is clear. The EC could establish actionable responsibilities for foreign investors by allowing a host country or affected third party, such as a trade union or a local community, to bring a claim (or, more modestly, a counter-claim) against a foreign investor *in the very same process* that is used to enforce foreign investor protections in a fair, independent, and open way.[5] That is a basic test for evaluating "balance" in the EC's proposals.

3. ISDS is alive in the EC's proposals

From the start, the EC's approach to foreign investor protection has been based on the deeply flawed and widely criticized process of investor-state dispute settlement.[6] In its new TTIP proposal, the EC introduces a new acronym to describe ISDS: ICS, which stands for "investment court system".[7]

Although the details have positive elements, after a study of the text it became clear that ICS is mainly a re-branding exercise for ISDS. Too many flawed elements of ISDS remain – including elements that give rise to unacceptable appearances of bias among ICS "judges" – to use terms like court and judge without being misleading to the uninitiated.

Most importantly, ICS "judges" would continue to have a financial interest in future claims because they are still paid a (lucrative) daily fee in a context where only one side – foreign investors – can bring claims,[8] they would continue to operate under the usual ISDS arbitration rules,[9] they would not have to meet the requirements for judicial appointment in any country,[10] and they would not be barred from working on the side as ISDS arbitrators.[11]

[4] In its proposals, the EC has called into question the effectiveness of domestic institutions to protect foreign investors. Yet, if one accepts the EC's concern about domestic institutions, it follows that domestic institutions may fail to enforce foreign investors' responsibilities too. There is a basic imbalance in establishing powerful and highly-enforceable rights, but not responsibilities, for foreign investors.

[5] It is especially important that the process be the same so that awards for or against foreign investors are both internationally enforceable.

[6] ISDS is widely and rightly criticized because of its inappropriate reliance on arbitration to make final decisions about public law and policy and about the award of public funds to private actors. Most ISDS cases involve challenges to laws, regulations, judicial decisions, or other sovereign decisions affecting a range of constituencies in society. In this context, the use of arbitration conflicts with principles of democratic and public accountability, regulatory capacity, budgetary flexibility, judicial independence, and procedural fairness. For a discussion, see G Van Harten, *Investment Treaty Arbitration and Public Law* (Oxford: OUP, 2007) ch 7; G Van Harten, *Sovereign Choices and Sovereign Constraints* (Oxford: OUP, 2013) ch 1 and 4.

[7] European Commission, "Commission proposes new Investment Court System for TTIP and other EU trade and investment negotiations", Press release (16 September 2015).

[8] EC Proposal, above note 1, Section 3, Article 9(14) (linking financial remuneration to frequency of claims by incorporating generous daily rates paid to ISDS arbitrators under the ICSID regulations).

[9] EC Proposal, above note 1, Section 3, Article 6(2) (allowing for foreign investor claims under the ICSID Rules, ICSID Additional Facility Rules, and UNCITRAL Rules, all of which are commonly-used arbitration rules in ISDS).

[10] EC Proposal, above note 1, Section 3, Articles 9(4) and 10(7) (facilitating the appointment of the non-judges who currently dominate ISDS by adding the flexible category of "jurists of recognised competence").

[11] EC Proposal, above note 1, Section 4, Article 11(1) (omitting the word "arbitrator" from the list of prohibited side roles of ICS "judges").

There is one promising signal in the EC's proposals – an apparent commitment to establish a proper international court to replace ISDS in existing treaties[12] – yet this aspect of the proposal unfortunately is put in doubt by the EC's choices about sequencing, as I discuss below.

4. The EC's proposals put poison pills into the "right to regulate"[13]

The EC has proposed to put a right to regulate into the TTIP text.[14] However, in the relevant text, the EC has included poison pills that appear designed to kill the right to regulate in future ISDS cases. The key poison pills are as follows.

i. The wording of the right to regulate in Article 2(1) includes a "necessity test" for state decisions that are protected by the right to regulate. While this test might sound reasonable on its face, it has been applied in exceedingly strict ways by a large majority of ISDS tribunals faced with the issue.[15] One who knows the record of ISDS tribunals therefore should also know that a necessity test is a sure way to make it very difficult for a challenged law, regulation, or other decision to qualify for protection under the right to regulate.[16]

ii. The wording of the right to regulate in Article 2(1) – when interpreted in the context of the expressed prohibition on any requirement for states "to compensate the investor" that is included in Article 2(4) but not in Article 2(1)[17] – makes it implicit that compensation orders by ISDS tribunals for new laws, regulations, or other decisions are not precluded or limited by

[12] European Commission, above note 3 ("… the Commission will start work, together with other countries, on setting up a permanent International Investment Court. The objective is that over time the International Investment Court *would replace all investment dispute resolution mechanisms provided in EU agreements, EU Member States' agreements with third countries and in trade and investment treaties concluded between non-EU countries*. This would further increase the efficiency, consistency and legitimacy of the international investment dispute resolution system.") (emphasis added).

[13] The "right to regulate" in foreign investor protection system is a euphemism for decision-making by institutions of democracy, regulation, government, and courts in countries. Using the term reduces the role of these institutions to a position of equality with foreign investor protection and compensation in the international obligations of the state. Keeping that in mind, it is instructive that the EC did not include any statement to affirm the right to regulate in the investment chapters it proposed in the CETA with Canada or the FTA with Singapore.

[14] EC Proposal, above n 1, Section 2, Articles 2(1) and 2(2). The problematic language in Article 2(1) is italicized in the following text of Article 2(1): "The provisions of this section shall not *affect* the right of the Parties to regulate within their territories through measures *necessary* to achieve legitimate policy objectives, such as the protection of public health, safety, environment or public morals, social or consumer protection or promotion and protection of cultural diversity." For stronger language that precludes ISDS compensation orders and that does not apply a necessity test, albeit only to protect certain types of subsidies, see Articles 2(3) and 2(4).

[15] G Van Harten, *Sovereign Choices and Sovereign Constraints* (Oxford: OUP, 2013), p 66-68.

[16] For example, the necessity test has been applied to require that a country made no contribution to the state of affairs requiring the passage of the law or regulation and that the country selected the policy option that would have the least impact on the foreign investor (in circumstances where the state often cannot know with reasonable predictability how an ISDS tribunal will assess its past policy options in an ISDS proceeding and the foreign investor's lawyers can be expected to attack whatever policy option the state did choose to adopt). Ibid.

[17] The explicit override, which is missing from Articles 2(1) and 2(2), is italicized in the following text of Article 2(4): "For greater certainty, nothing in this Section shall be construed as preventing a Party from discontinuing the granting of a subsidy and/or requesting its reimbursement, *or as requiring that Party to compensate the investor therefor*, where such action has been ordered by one of its competent authorities listed in Annex III." EC Proposal, above n 1, Section 2, Articles 2(1) and 2(2).

the right to regulate in Article 2(1). This discrepancy creates a critical gap in the EC's proposal because compensation orders, and the potentially huge price tag they put on state decisions,[18] are at the heart of the concerns about ISDS and the right to regulate.

iii. Similarly, in Article 2(2), the wording of the state's right to "change the legal and regulatory framework", read again in the context of Article 2(4), makes it implicit that compensation orders for legal or regulatory changes are also not precluded or limited by the state's right in Article 2(2).

iv. Although Article 2(2) appears to block awards of expected profits, the compensation orders mentioned in items ii. and iii. above would typically include future lost profits for foreign investors.[19] As I explained above, Article 2(2) does not apply to compensation orders by ISDS tribunals. As a result, the language in Article 2(2) on lost profits evidently would not apply to compensation orders. Rather, the arbitrators' general power to award monetary compensation, which is used regularly to award lost profits, would take over. In the EC's proposal, this general power is found in Article 28(1).[20]

These textual details greatly undermine the EC's proposal on the right to regulate and the right to change the legal and regulatory framework. Indeed, they suggest that the EC may be pretending to protect the right to regulate while leaving catches in the text that return us to the usual concerns about ISDS. The text on this point is a good case study for how legal language can be written in ways that may give a false impression of security to the uninitiated.

Under the EC's proposal, foreign investors can still use ISDS – as they have in most ISDS cases so far – to attack state decisions in areas of agriculture, consumer protection, culture, energy, environment, financial security, intellectual property, land use, mining, public health, taxation, or transportation.[21] Likewise, ISDS tribunals can still order vast and uncapped amounts of public compensation for foreign investors in any of these areas.[22] The EC's proposal does not alter this situation.

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[18] See G Van Harten, *Sold Down the Yangtze: Canada's Lopsided Investment Deal with China* (Toronto: Lorimer, 2015), p 96-100.

[19] The language in Article 2(2), with the weaker language italicized, is as follows: "For greater certainty, the provisions of this section *shall not be interpreted as a commitment* from a Party that it will not change the legal and regulatory framework, including in a manner that may negatively affect the operation of covered investments or the investor's expectations of profits." EC Proposal, above n 1, Section 2, Article 2(2).

[20] This assessment is based on the regular practice of ISDS tribunals to award future lost profits to foreign investors under the tribunals' general power to award damages under Article 28(1). I do not see this general power as being limited by the language in Article 2(2) that refers to expected profits in the context of how foreign investors' protections are "interpreted". The interpretation of the substantive obligations of foreign investor protection is a separate step from the award of damages under Article 28(1). EC Proposal, above n 1, Section 3, Article 28(1).

[21] G Van Harten, *Sovereign Choices and Sovereign Constraints* (Oxford: OUP, 2013), p 10-14 and 82-89.

[22] Instead, the relevance of the new substantive language in the EC's proposal is to the likelihood of success of future ISDS claims. On this issue, the proposal as a whole does not make a clear difference either way when compared to the text of the CETA with Canada, for example. If pressed, I would say that the EC's TTIP proposal increases the overall likelihood of success for foreign investors due to the inclusion of a (risky for taxpayers) umbrella clause, which among other things clearly outweighs any benefit from the Article 2 language on the right to regulate and on changes to the regulatory framework due to the poison pills in Article 2.

5. The EC's proposal remains disrespectful of domestic institutions, including the courts

The EC's proposal is still premised on an assumption that the courts in Europe and the U.S. are so flawed that foreign investors should be able to bring an ISDS claim without even having to explain why it would be unreasonable for the foreign investor to seek relief first in the courts.

This assumption is inherent in the EC proposal not to include the usual duty of all individuals to go to a country's courts, where they offer justice, before pursuing an international remedy.[23] Foreign investors alone have been excused from this duty, thus exacerbating the imbalances created by ISDS.

Instead of including a standard duty to exhaust local remedies, the EC has introduced a complex "U-turn" clause. This clause prevents foreign investors from turning back from ISDS, once they have resorted to ISDS. Yet it does not require foreign investors to use the courts first or to explain why they are going to ISDS instead of the courts. Foreign investors can choose to avoid the courts, they can turn back from the courts to pursue ISDS instead, and they can use ISDS to seek compensation for a court's decisions at any level of the judiciary.

This arrangement is an extraordinary privilege for foreign investors, not available to anyone else who may need international protection. Domestic investors and citizens must deal with the usual risks of democracy and regulation in the usual ways: by taking part in the democratic process, by buying insurance, by bargaining for strong dispute settlement clauses in their contracts with government, or by relying – like everyone else – on the courts.

6. If the EC is serious about an international investment court, why is it proposing to expand ISDS in the TTIP?

The concern remains that the EC is using the language of an international investment court to give cover for a massive expansion of ISDS.[24]

As noted earlier, the EC's ICS proposal falls well short of establishing a court with independent judges. And, while the EC has signalled that it will work toward a full-blown international court to replace ISDS, if that is the goal then the EC's sequencing appears backwards. Logically, the EC should be pushing to transform existing treaties so that ISDS is replaced with an international court before the EC goes to the U.S. with its relatively weak proposals on ICS. In the past, the U.S. government has not welcomed the idea of new international courts.

[23] The duty to resort to domestic courts before seeking an international remedy is important for many reasons. It creates an intermediary between domestic institutions and international review; it allows an international tribunal to see how domestic courts characterize and resolve a dispute in the context of domestic law; it respects domestic institutions by giving them an opportunity to resolve a dispute; it checks undesirable legal maneuvering; it supports the principles of sanctity of contract and party autonomy in the marketplace by requiring foreign investors to resort to any contractually-agreed remedies; and it creates an incentive for foreign investors to consider carefully the reliability of a country's institutions when deciding whether to enter the country.

[24] If the TTIP is concluded, it would roughly triple the scope of the foreign investor protection system beyond all existing ISDS treaties. It would also expand greatly the exposure of the United States and Western European governments to ISDS. Other trade agreements – such as the CETA with Canada or the FTA with Singapore – would also expand the scope of foreign investor protection significantly. Finally, like the TTIP, they would make it very difficult for countries to withdraw from ISDS. At present, countries are in a position where they can terminate the hundreds of bilateral investment treaties that allow for ISDS. With the proposed TTIP, CETA, and FTA, ISDS would be embedded in a larger trade agreement on which broad sectors of a country's economy would become dependent over time.

The fact that the EC has done the opposite – by floating a modified version of ISDS with the U.S. before pursuing a proper court with other countries –seems to undermine the EC's credibility on the issue of an international investment court.

Conclusion

For at least six reasons, the EC's proposal for foreign investor protection in TTIP is flawed.

1. There is still no compelling, evidence-based justification for including extraordinary protections for foreign investors in the TTIP and similar agreements.

2. The proposal does not include any responsibilities for foreign investors that can be enforced in the same process as foreign investors' elaborate rights and protections.

3. ISDS lives on in the details of the EC's proposal.

4. The EC has put poison pills into the details of the "right to regulate".

5. The proposal remains disrespectful of domestic institutions.

6. The EC's proposal for an international investment court lacks credibility because the EC has proceeded first with a proposal for ISDS in the TTIP.

There is a viable alternative to this state of affairs. The EC could decline to pursue new treaties based on ISDS and work to establish an international judicial process that replaces ISDS in existing treaties. It could ensure that the law of foreign investment is balanced by permitting foreign investor rights and responsibilities to be enforced in the same process. It could ensure that this area of law is respectful of domestic institutions based on longstanding principles of international legal protection for all individuals. The EC could do all of these things, and it should.