

“ISDS” IN THE TTIP

THE DEVIL IS IN THE DETAILS

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SUMMARY

What should we think about an investor-state dispute settlement (ISDS) mechanism being included in the proposed Transatlantic Trade and Investment Partnership (TTIP)?

This issue has led to particularly vigorous debate in Europe as the volume of foreign direct investment (FDI) has increased considerably worldwide over the last decade and has become a key economic growth factor for the most attractive countries.

93% of bilateral investment treaties (BITs) contain an ISDS. An ISDS mechanism has been introduced systematically into investment agreements between developed and developing countries. But its inclusion in agreements between developed economies, such as Canada and the EU, or the United States and the EU, raises new issues.

Given the tension surrounding this subject, **this policy paper aims to clarify the debate by, firstly, drawing up an overview of the use of ISDS worldwide and in the transatlantic space over the last fifty years.** Not only did European countries initiate these investor protection mechanisms from the 1960s onwards, but they were also those who made the most use of them, filing the most claims. However, the increasing number of claims worldwide over the last decade gives rise to new fears today.

Although it remains uncommon, certain countries have chosen not to renew their bilateral investment treaties which included an ISDS (Bolivia, Venezuela, Ecuador), or to withdraw from treaties including ISDS (South Africa), or even to reserve the right to determine the need to use ISDS on a case-by-case basis (Australia).

“**ADVOCATING THE DEVELOPMENT OF ALTERNATIVES OR THE ADJUSTING OF THE ISDS MODEL?”**”

This policy paper then scrutinises the various arguments given in the debate. On the one hand, the business world advocates instruments like ISDS to attract FDI, as they guarantee a safe, predictable legal framework and depoliticised dispute settlement. On the other hand, detractors believe that ISDS is an illegitimate or pointless instrument in the framework of the TTIP and consider that it would undermine the ability of sovereign nations to legislate. Lastly, the negotiators are seeking to accommodate the different positions while bearing in mind the geostrategic advantages of including an ISDS mechanism in the TTIP.

The devil is hidden in the details of these various issues, and that is where we need to seek arguments advocating the development of alternatives or the adjusting of the ISDS model.

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INTRODUCTION

The negotiations for a Transatlantic Trade and Investment Partnership (TTIP) had barely begun in summer 2013 when the inclusion of an investor-state dispute settlement (ISDS) mechanism, included in the negotiating mandate given to the European Commission,¹ loomed large in the public debate as a potential obstacle to ratification of the final agreement.

“THE INCLUSION OF AN ISDS MECHANISM LOOMED LARGE IN THE PUBLIC DEBATE AS A POTENTIAL OBSTACLE TO RATIFICATION OF THE FINAL AGREEMENT”

work for international investors as well as a depoliticised form of dispute settlement, so as to facilitate decisions and investments.

This legal mechanism allows foreign investors to make claims directly against a state, submitting them not to national courts but rather to an arbitral tribunal. The provisions defining such a mechanism are based on a prior agreement signed between two governments in the framework of a bilateral investment agreement or, in the case of the TTIP, in the investment chapter of a more wide-ranging free trade agreement. Investors can submit complaints if they consider that the state has violated the rules of the investment treaty that protects their rights. ISDS aims to guarantee a safe, predictable frame-

The great number of investment agreements signed in recent years and the very large increase in ISDS claims illustrate the importance and attractiveness of such instruments for investors. The available statistics show that the use of ISDS has become commonplace and is now a reality of the investment world.

But it is the high number of disputes and the media attention accorded to certain cases² that have dominated the public debate and given rise to criticism concerning the limitation of the sovereign power of states to legislate.

Those fears have now led to policy reversals around the world. Some countries have officially rejected the advantages of such an instrument, while others have now announced their decision not to renew their existing trade agreements that include ISDS mechanisms.

Criticism of the inclusion of such a mechanism in the TTIP has grown within Europe’s civil society and the European Parliament. The conclusions of the public consultation held from March to July 2014 could thus lead the new Commission – presided by Jean-Claude Juncker, who himself criticised the mechanism during campaigning for the European elections in spring 2014 – to review its position on the subject.

The explosion in FDI stocks over the last decade,³ the increasing proportion of investors from developing countries, the diversification of host countries and the new multinational structure of many companies are all factors that should lead to a reassessment of the suitability of current ISDS systems.

Can they limit the ability of states to legislate or increase the influence of multinational enterprises in global governance? Do these legal instruments genuinely contribute to creating a favourable investment environment? Is the mutual confidence of Americans and Europeans in each other’s national courts insufficient? What

1. See Annex

2. *Vattenfall v. Germany*: in 2012, the Swedish electricity generation and distribution company Vattenfall filed a claim against the German Federal Government concerning the closure of its German nuclear power plants, following the Government’s 2011 decision to abandon nuclear power. It demanded compensation of €4.7 billion. *Lone Pine v. Quebec*: The US oil company Lone Pine sued the Canadian Government under the North American Free Trade Agreement (NAFTA), against the Province of Quebec’s moratorium on hydraulic fracturing and shale gas extraction, demanding USD\$250 million in compensation. *Philip Morris vs Australia*: see § 2.6. p. 15

3. UNCTAD, *World Investment Report 2014*, p. 2.

are the geostrategic issues? Should the TTIP be seen as an opportunity to promote a new, more rigorous ISDS standard that could be a model for other countries?

We will analyse the arguments for and against the inclusion of an ISDS mechanism in the TTIP, after sketching out an overview of its use around the world and in the transatlantic space.

1. Overview of ISDS worldwide: commonplace and contested

1.1. Principles and functioning of ISDS

Bilateral Investment Treaties (BITs) are agreements ratified between two sovereign states. Investment treaties, like the investment chapters of free trade agreements, can be bilateral, regional – like the North American Free Trade Agreement, NAFTA – or plurilateral – like the Energy Charter Treaty, or ETC – and provide a legal framework for foreign direct investment (FDI) that can help strengthen investor confidence and the attractiveness of a country.

“ALMOST ALL OF THE
3,200 BITs CONTAIN AN
ISDS MECHANISM”

To date, and since the first bilateral investment treaty signed between Germany and Pakistan in 1959, some 3,200 BITs and free trade agreement investment chapters have entered into force worldwide, between 180 countries.⁴

Under the most-favoured-nation (MFN) rule, whereby foreign investors may not receive less favourable treatment than investors from the most favoured nation, these treaties enshrine four general principles:

- Protection against discrimination: national and most-favoured-nation treatment clauses ensure that the host state treats foreign investors in the same way as national investors and the best-treated foreign investors.
- Protection against expropriation without adequate compensation. This also covers indirect expropriation, which could be caused by regulations significantly reducing the value of an investment.
- Protection against unfair and unequitable treatment.
- Protection of capital transfers: host countries may not limit transfers of capital.

In order to ensure compliance with these principles, agreements offer the possibility of filing claims with local courts, as well as – in almost all of them⁵ – taking cases to international private arbitration via ISDS.

There is not so much one ISDS model as a great variety of possible combinations of options. There are almost as many models as there are different wordings and content in each agreement. However, these agreements share the following basic characteristics:

- Investors can initiate an arbitration procedure against host states where they consider that the latter has breached the terms of the prior agreement by taking steps that violate the aforementioned general principles. Such steps can be decisions, laws or policy changes (executive, judicial or legislative).

4. United Nations Conference on Trade and Development (UNCTAD), *International Investment Policymaking in Transition: Challenges and Opportunities of Treaty Renewal*, No. 4, June 2013.

5. The OECD estimates that 93% of investment treaties provide for international arbitration. OECD, *Investor-State Dispute Settlement*, 2012.

- The parties appoint an *ad hoc* arbitration panel made up of three arbitrators. Each party chooses one arbitrator, and the third is chosen by mutual agreement or by an authority invested with the power to appoint an arbitrator.
- Almost all BITs require or recommend prior efforts to settle disputes amicably before arbitration procedures begin.
- If the host state is found responsible for breaching the BIT signed between the host state and the investor's home state, the arbitral tribunal will determine the compensation to be paid to the investor (almost exclusively financial).
- The final arbitration award is binding. On the face of it, such awards can only be contested under exceptional circumstances and no appeal mechanism is provided for.

Each agreement includes clauses indicating which bodies and which set of rules shall be used to settle disputes. This can involve an international body (the two main bodies being the International Centre for Settlement of Investment Disputes, ICSID, created by the World Bank and the UN Commission on International Trade Law, UNCITRAL), or the *ad hoc* arbitration rules proposed by the Permanent Court of Arbitration in the Hague or the Stockholm Chamber of Commerce Arbitration Institute, for example. These institutions are impartial and do not arbitrate cases themselves. The various systems define rules of arbitration, provide their logistical resources and generally enable the creation of *ad hoc* panels where the neutrality of judges must be ensured.

1.2. The failure of a multilateral channel for investment

A comparison with the existing World Trade Organization (WTO) mechanism for settling disputes in the trade of goods and services is useful to assess the specificity of two systems and their impact in a context of rapidly increasing FDI.

The difference between the two systems is first and foremost structural: the WTO's dispute settlement mechanism resolves differences between two states; in the event of anticompetitive treatment, investors can turn to their home states with the aim of either finding an amicable solution with the host state through diplomatic channels or resorting to WTO dispute settlement.

Their rulings also produce measures of a completely different nature. In private international arbitration between investors and states, if the prejudice suffered by investors is judged irreparable, then they must receive full financial compensation, whereas for disputes relating to goods and services handled at the WTO, the Dispute Settlement Understanding (DSU) may involve the accused state agreeing to withdraw the measure judged incompatible with WTO rules with no other financial compensation.

Moreover, on the one hand, the WTO authorises the publication of rulings and, in most cases, debates, whereas the private international arbitral tribunals are criticised for their lack of transparency.

On the other hand, during the negotiation of the agreements establishing the WTO, it was considered that the rulings of the dispute settlement body could have severe consequences for the member states and that a mechanism for appellate review should be created. There is no such mechanism in private international arbitration; there is only an annulment procedure provided for by the International Centre for Settlement of Investment Disputes (ICSID), which can only be invoked in cases of extreme injustice.

Lastly, while the trade in goods and services is governed by the WTO rules, there is no comparable multilateral legal framework for FDI, concerning either market access rules or investment protection mechanisms.

The overall landscape of international investment agreements (IIA) is a mosaic made up of thousands of bilateral, regional and plurilateral agreements. Current international jurisprudence in the area of investment stems from those various agreements. It is established on a case-by-case basis by arbitration awards and thus remains fragmented and chaotic, with different levels of protection depending on the origin and destination of investment flows, while rules overlap and are sometimes contradictory.

The advantage of a system of multilateral rules would be to harmonise international investment law and provide a clearer, more inclusive framework for states and investors. It could also offer a centralised mechanism for conflict resolution with an appellate body to uphold a coherent legal framework in the face of the differences of the various agreements.

“ THE MULTILATERAL CHANNEL HAS BEEN ATTEMPTED ON SEVERAL OCCASIONS, WITHOUT SUCCESS”

The multilateral channel has been attempted on several occasions, without success. Following the failure of the OECD project in 1967 aimed at negotiating a Convention on the Protection of Foreign Property, a Code of Conduct on Transnational Corporations was envisaged by the United Nations in 1986 to contribute to achieving the development goals of the countries where they were present. In 1995, the OECD once again attempted to negotiate a Multilateral Investment Agreement (MIA) advocating high standards for the liberalisation of investment regimes and investment protection, and effective dispute-settlement procedures. Certain WTO members wished to include this goal in the Doha agenda.

The failure of the MIA and the increasing heterogeneity of the WTO's members – with the arrival of increasing numbers of emerging economies with disparate interests – was not conducive to the resumption of multilateral investment negotiations in the short term.

1.3. Historic phases

The lack of multilateral coordination thus led to the active development of bilateral investment treaties (BIT) and ISDS models. Four major periods can be distinguished.

- The Europeans initiated the first phase of BIT development in the late 1950s and the 1960s, as least developed countries (LDC) proceeded with nationalisations of foreign businesses during decolonization in order to take back control of their natural resources. The transitional phase prior to the establishment of the rule of law in those countries led to abuses with regard to foreign investors,⁶ leading the Europeans to strengthen FDI protection by replacing inter-state dispute settlement with investor-host state dispute settlement, allowing investors to submit claims to the International Court of Justice (ICJ).

Arbitration did however still require prior authorisation from the host state.

“ THE EUROPEANS INITIATED THE FIRST PHASE OF BIT DEVELOPMENT”

Germany had already signed more than 46 BITs with developing countries by 1972 and was considered one of the most active exporting countries in this respect. Yet it had not adopted an effective arbitration mechanism enabling investors to unilaterally request arbitration for a wide range of disputes and thus apply directly to the national courts of the country.

- Only in the 1980s did the proliferation of bilateral investment agreements initiated by the Europeans lead the United States to launch their own programme of bilateral agreements (the US signed its first BIT in

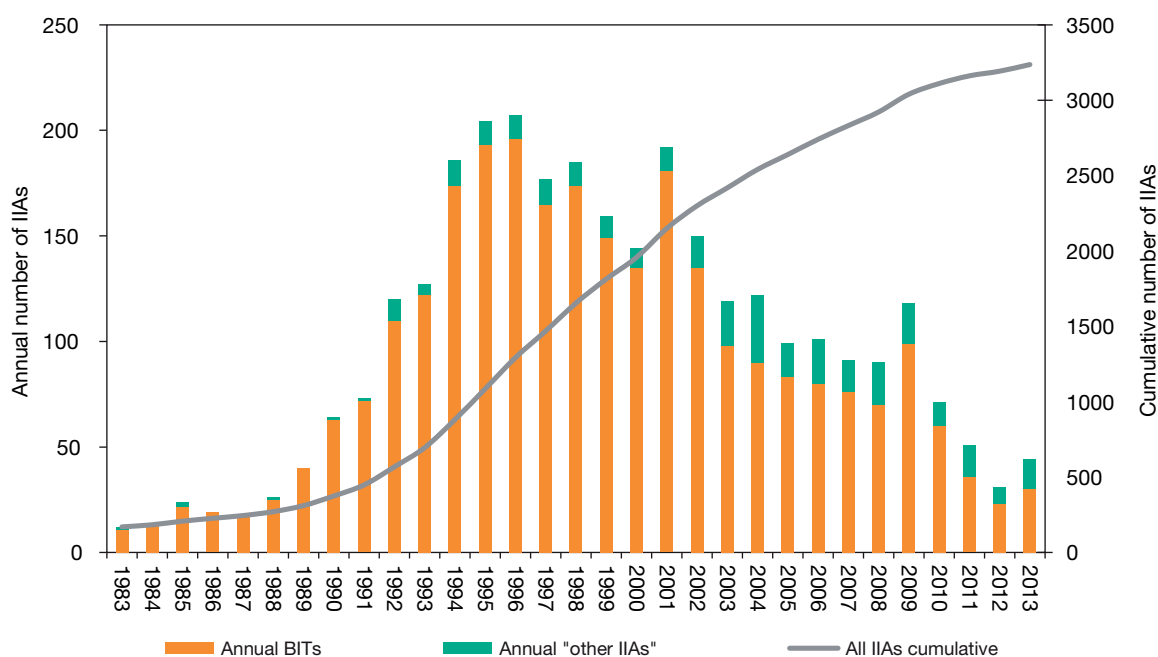
6. Data on expropriations of foreign direct investment show a proliferation of such acts in the 1960s and 1970s, slowing to a trickle thereafter. There were 136 expropriation acts in the 1960s and 423 in the 1970s; but then only 17 in the 1980s, 22 in the 1990s, and 27 from 2000 to 2006. Christopher Hajzler, "Expropriation of Foreign Direct Investments: Sectoral Patterns from 1993 to 2006," *Review of World Economics (Weltwirtschaftliches Archiv)* 148, no.1 (2012): pp.119– 49. According to Simon Lester, 24 countries proceeded with expropriations between 1989 and 2006 ["Liberalization or Litigation? Time to Rethink the International Investment Regime", *Policy Analysis*, Cato Institute, no.730, 8 July 2013, p. 14]

1982), developing clauses making it possible to file claims directly without the prior agreement of the host state.

Germany waited until its BIT with Nepal in 1988 to adopt arbitration clauses making it possible to file claims directly without the prior agreement of the host state.

- A new generation of BITs and free trade agreements (FTA), with more specific clauses for investor protection and exceptions, emerged following the signature of the North American Free Trade Agreement (NAFTA) between the United States, Canada and Mexico in 1994. This was the first plurilateral treaty between developed countries with an ISDS system. Greater attention is accorded to environmental protection, health and human rights issues in these agreements.

FIGURE 1 ► Trends in IIAs signed, 1983-2013



Source: UNCTAD, 2014.

- Lastly, the 2012 review of the American BIT model and the investment chapter in their bilateral free trade agreements⁷ marked a new paradigm in negotiations, with the launch of investment negotiations with countries such as China and India and in mega-regional frameworks like the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP). The EU's new competence in investment matters, enshrined by the Treaty of Lisbon in 2009, led the European Commission to develop a new ISDS model replacing the various models adopted by member states in order to successfully conduct bilateral negotiations with Singapore and Canada.

1.4. Major global investor protection trends

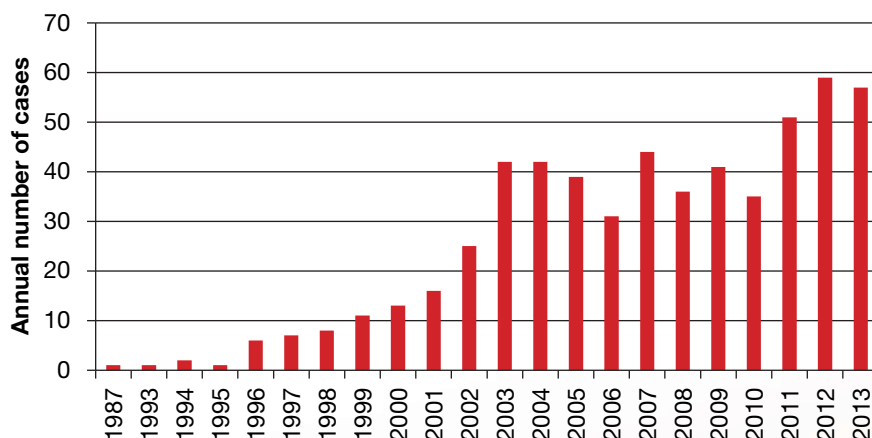
The use of ISDS mechanisms is a longstanding reality of the FDI world. As such, it is vital to refocus the debate in the context of the increasing number of BITs worldwide.

7. The review covered in particular the definition of fair and equitable treatment that was aligned on customary international law in order to restrict its scope, as well as the enhancement of the aspects concerning environmental and employment legislation.

There was an increase in bilateral investment agreements in the 1990s. The number of BITs increased five-fold between the late 1980s and the end of the 1990s (from 385 to 1,857⁸) and, despite a slowdown in the number of new treaties starting from the 2000s, there is now a total of 3,200 worldwide.

The external stock of foreign direct investment has also grown remarkably, increasing ten-fold over 20 years with a growth from USD\$2,400 billion in 1992 to USD\$23,600 billion in 2012.⁹

FIGURE 2 ► Known ISDS cases, annual (1987-2013)



Source: UNCTAD, April 2014.

CONSIDERABLE INCREASE FROM THE 2000s ONWARDS WITH A TOTAL OF 568 CLAIMS SUBMITTED BETWEEN THE FIRST ISDS SYSTEMS AND THE END OF 2013"

Those trends came with a considerable increase in the number of claims filed with international arbitral tribunals from the 2000s onwards, with at least 30 new cases per year from 2003 and record numbers of claims submitted since the beginning of the crisis in 2008.

The latest UNCTAD study on the development of ISDS¹⁰ mechanisms identified a total of 568 claims submitted between the introduction of the first ISDS systems and the end of 2013. However, as most arbitration forums do not maintain a register of claims, the total number of disputes is probably greater.

The sectors concerned by such claims are traditionally those with the most state involvement (government property, strong regulation and/or subsidies), such as oil and gas, mining, forestry, agriculture, construction and management of infrastructure, telecommunications, energy, finance, tourism, water and waste management and the media.

Such disputes are generally related to steps taken to combat the financial crisis, the cancellation of concessions and permits, changes to environmental and tax legislation, adjustment of export duties and licence fees, failure to comply with investment contracts, privatisation or nationalisation of companies, etc.

In addition, although this phenomenon remains small-scale, a change of strategy has also been observed on the part of certain countries, leading them to abandon the use of ISDS.

Bolivia, Venezuela and Ecuador have withdrawn from ICSID and have not renewed certain BITs. South Africa plans to withdraw from treaties including ISDS mechanisms and strengthen their national jurisdictions. Indonesia has announced that it does not intend to renew treaties of this type when they expire. Lastly,

8. UNCTAD, *Bilateral Investment Treaties, 1959-1999* UNCTAD/ITE/IIA/2, 2000.

9. UNCTAD, *World Investment Report, Global Value Chains: Investment and Trade Development*, 2013

10. UNCTAD, "Recent Developments in Investor-State Dispute Settlement (ISDS)", *IIA Issue Note*, No. 1, April 2014, at 1.

Australia reserves the right to determine the need for use of ISDS on a case-by-case basis, and notably eliminated any provision concerning investor protection from its 2004 free trade agreement with the United States.¹¹

1.5. The distribution of disputes around the world: home states and host states

Investors based in major capital-exporting economies are those that most often make use of ISDS. Investors from developed countries thus initiated 85% of the claims submitted between 1987 and the end of 2013.

Out of the 98 countries targeted by the known claims, about three quarters were developing countries or in transition, while only 27% of claims were against developed countries.

The countries that received the most claims were Argentina and Venezuela, followed by the Czech Republic, Egypt, Ecuador, Canada, Mexico, Poland and the United States.

1.6. ISDS in the USA and in the EU

To date, the United States has signed investment agreements with 57 countries and is promoting its ISDS model, although those agreements still only cover 21% of its FDI stock.

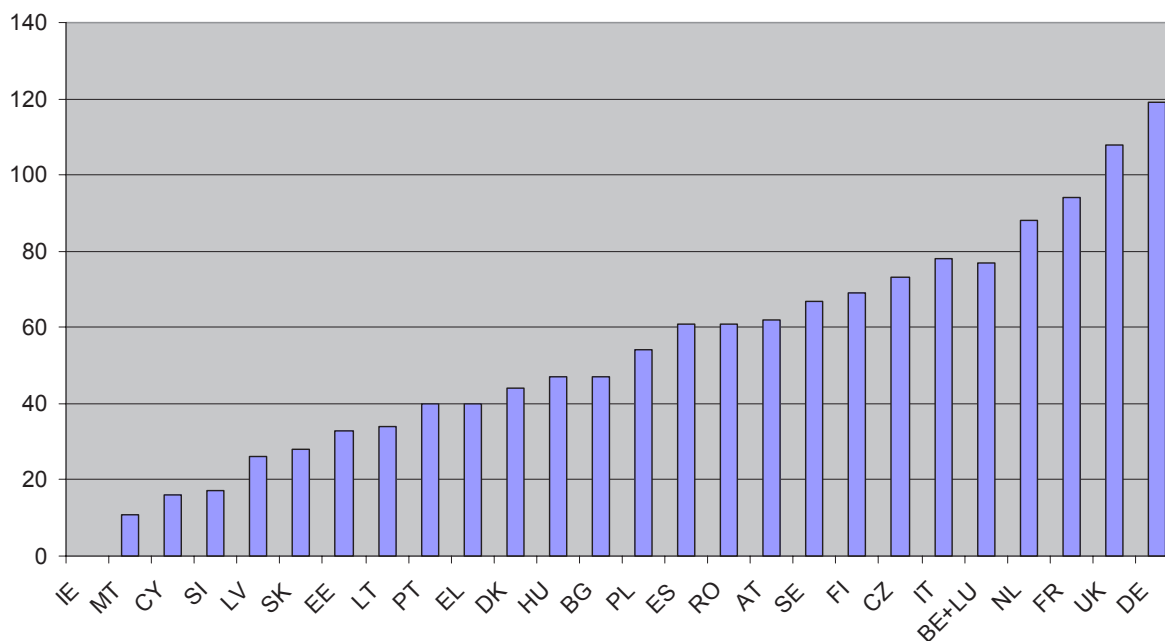
The EU, meanwhile, has so far ratified only one treaty containing an ISDS mechanism, the 1994 Energy Charter Treaty (ECT) which has 53 members, and has entered into two free trade agreements containing ISDS provisions: one with Singapore in December 2012, and one with Canada in September 2014. These two agreements have not yet been ratified.

“EU MEMBER STATES ARE PARTIES TO A TOTAL OF 1,356 BITS SIGNED WITH THIRD COUNTRIES, PLUS AROUND 190 BITS BETWEEN EU MEMBERS”

However, EU member states are parties to a total of 1,356 BITS signed with third countries, in addition to around 190 BITS between EU members, although member states have developed very different strategies: while Germany has signed 131 of them, France has signed only 91 and Ireland has signed none.

11. - Australian BITs traditionally included ISDS provisions until this agreement signed in 2004 with the United-States which did not contain any. Chilled by the claim of the American firm Philip Morris in 2011 via the BIT signed with Hong Kong in 1993, the Gillard government had then decided to avoid including any ISDS provision in BITs. But Australia did sign a free trade agreement with South Korea in 2013 that contained an ISDS, and recently concluded an agreement with China on 17 November 2014, which also contained one. It would be prepared to accept such a system being included in the Trans-Pacific Partnership that is still being negotiated.

FIGURE 3 ► Overview of the number of Bilateral Investment Treaties concluded by EU Member State



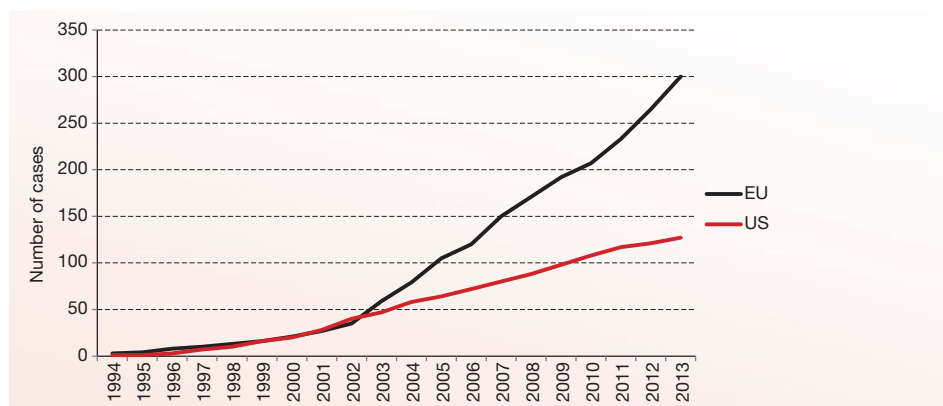
American and European investors initiated 75% of all identified claims.¹²

IT IS THE EUROPEANS WHO INITIATED THE MOST CLAIMS"

The United States is at the top of the global league table of home states whose investors have filed the most claims, and an American "culture of litigation" is often mooted.

However, if all the claims submitted by all EU member states are grouped together, it is the Europeans who initiated the most claims (300 from the 28 member states put together).

FIGURE 4 ► ISDS cases filed by the US and EU Member States, cumulative



Source: UNCTAD, June 2014.

The volume of the FDI stock between the United States and the EU is, on both sides, the largest in the economy: the Europeans represent 62% of FDI in the USA (USD\$1,600 billion), while the United States accounts for 38%

12. UNCTAD, January 2014.

of FDI in the European Union (USD\$1,900 billion). Europe has attracted 56% of American FDI since the turn of the century.¹³

However, most member states have not yet signed investment agreements with the United States:¹⁴ only nine of them (Bulgaria, Croatia, the Czech Republic, Estonia, Latvia, Lithuania, Poland, Romania and Slovakia¹⁵) have entered into agreements incorporating an ISDS mechanism.

“75% OF CLAIMS
SUBMITTED TO
MEMBER STATES WERE
INTRA-EUROPEAN”

The United States has received only 16 claims, while the Europeans have received 117. It is, however, important to bear in mind that 75% of claims submitted to member states were intra-European.

There have so far been nine claims between the United States and the EU, all submitted by American investors (4 against Poland, 3 against Romania, 1 against the Czech Republic and 1 against Estonia), representing 7% of total claims filed by US investors.

Investors from the US and the EU have won only one third of cases and reached a settlement for an additional quarter of recorded claims.

2. Arguments for and against ISDS

2.1. The harmonisation of investment dispute settlement rules

“THE NEW EU COMPETENCE
IN INVESTMENT MATTERS
CALLS FOR A HARMONISATION
OF THE LEGAL APPROACH OF EU
MEMBER STATES ON THE ISDS
MECHANISM”

The exclusive competence accorded to the EU in foreign trade matters following the creation of a customs union only gave it powers for certain aspects of cross-border investments (such as the services sector). Until the entry into force of the Treaty of Lisbon, the member states thus retained general competence for the conclusion of BITs, investor protection regulations and treatment after establishment. The EU was generally competent for access to investment markets, but did not have a comprehensive approach to international investments.¹⁶

By allowing the EU to negotiate all aspects related to FDI¹⁷ on behalf of EU member states, the Treaty of Lisbon makes it a single, coherent player on the international stage in the field of trade and investment.

Thus the European Commission is currently negotiating investment agreements with China and Myanmar. It has begun negotiating or updating trade agreements incorporating investment chapters with India, Japan, Morocco, Thailand and Vietnam.¹⁸ All these agreements mention ISDS. As of late 2014, none of those agreements has taken effect; only the agreements with Canada and Singapore have been concluded and are awaiting ratification by the European Parliament and the Council.

13. Compared to 1.2% for China. Daniel S. Hamilton and Joseph P. Quinlan, *The Transatlantic economy 2014*, Center for Transatlantic Relations Johns Hopkins University | Paul H. Nitze School of Advanced International Studies, vol.1, 2014.

14. “Investor-State Dispute Settlement: An Information Note on the United States and the European Union”, *IIA Issue Note*, No.2, 2014.

15. All those countries were going to join the European Union, and the United States wished to sign investment agreements with them beforehand.

16. European Parliament, Directorate-General for External Policies of the Union, *The EU Approach to International Investment Policy after the Lisbon Treaty*, 2010.

17. That competence therefore does not cover portfolio investment, which describes short-term investments with a narrow focus on the rate of return, no managerial control and a partly speculative character.

18. http://europa.eu/rapid/press-release_IP-14-951_en.htm

This institutional reform does however require the phasing-out of all the intra-EU BITs that have been concluded. The European Commission has highlighted that the 190 intra-European BITs are not compliant with the principle of free competition applied in the Single Market, as they give an exclusive preferred status to the countries that have signed them, to the detriment of others. Those intra-EU agreements are still operational and it remains vital to phase them out in the framework of the debate around ISDS.

Moreover, before the competence of the EU was extended to cover FDI, each member state (apart from Ireland) individually negotiated a considerable number of BITs with a great many trade partners worldwide.

The member states did not sign the same agreements with the same countries, and the ratified agreements did not all adopt the same standards.¹⁹ This means that European businesses are not on a level playing field for their investments, as they do not benefit equally from agreements between their home and host countries. The transition to an integrated EU investment policy would therefore help harmonise legal approaches. It would also benefit foreign investors for whom the standardisation of legal rules would provide a single, simplified access route to the whole single market.

An investment agreement with the United States incorporating an ISDS clause would also allow the member states that have not signed a BIT with the US to enjoy a level playing field with the nine Eastern European member states that have done so.²⁰ The latter states had, moreover, adopted the ISDS model that preceded the new generation clauses that are proposed in the TTIP. Certain aspects of those older agreements were poorly defined or imprecise. The new investment agreement would allow these nine Eastern European countries, which have been the target of numerous disputes, to enjoy a more rigorous mechanism.

2.2. A geostrategic investment agreement

The current patchwork of bilateral agreements and inconsistent arbitral awards increase legal uncertainty for investors. Harmonising ISDS models would make it possible to offer a single set of standards for all investors and encourage the harmonisation of arbitral jurisprudence. In the absence of a multilateral legal body protecting FDI like the WTO's DSU, the negotiation of an ISDS model that is adopted on the regional and multiregional levels would be an intermediary step that could prove decisive in promoting multilateral rules.

“AN AGREEMENT BETWEEN THE US AND THE EU COULD LEAD TO A GENERALISATION OF STANDARDS AROUND THE WORLD”

The CETA, TTIP and TPP agreements - in which the US and the EU seek to promote their ISDS models - could help encourage a more coherent regional approach to one type of investment agreement model. Similarly, an agreement between the US and the EU, which together receive 40% of global FDI and represent 47% of all outgoing investments, could lead to a generalisation of standards around the world, paving the way for a future multilateral investment agreement.

There is therefore a geostrategic argument in favour of including an ISDS mechanism in the TTIP agreement, which deserves discussion. Successful negotiations would set a precedent for other negotiations with strategic partners such as China.

The US and the EU are currently negotiating separate bilateral investment agreements with China. If the EU successfully concludes a BIT with China, this treaty would be a step towards a bilateral free trade agreement.

Moreover, China is far from opposing investment agreements and arbitral tribunals. Initially, China imported capital. For decades, it signed agreements based on a model defending its perception of national economic interests. However, as the country gained importance as a capital exporter, its BIT model changed. Since the

19. European Parliament, *Ibid*, 2010, Table 9, p. 78 (Annex).

20. "Investor-State Dispute Settlement: An Information Note on the United States and the European Union", *JIA Issue Note*, No. 2, 2014.

late 1990s, Beijing has become increasingly accepting of international discipline as far as investment is concerned, going so far as to guarantee extensive procedural protection to its investors.

Recent Chinese agreements are therefore comparable to the standard European BIT model, with one major sticking point. China recognises the national treatment principle for foreign companies already present in the country, but has traditionally refused to extend this right to foreign investors seeking to access the Chinese market - cf. the pre-establishment phase - and sets maximum thresholds for foreign investment in state-owned enterprises.

Beijing has already expressed its willingness to make unprecedented concessions with respect to market access and accept American demands. The prospect of strengthened transatlantic ties would put further pressure on the Chinese government. However, if EU-US negotiations on including an ISDS mechanism in the TTIP are unsuccessful, China may use the failed agreement as an opportunity to omit similar mechanisms from future bilateral agreements with the EU and the US.

2.3. Benefits of a legal framework for investments

“INVESTORS PRAISE THE NEUTRALITY, FLEXIBILITY AND RAPIDITY OF ARBITRAL PROCEEDINGS, AND THE ENFORCEABILITY OF ARBITRAL AWARDS”

Investors may benefit from choosing international arbitration over national courts, given the neutrality of arbitral proceedings, the flexibility and rapidity of the arbitration process, and the enforceability of arbitral awards.

Foreign investors may be reluctant to be judged by courts located in the same countries that have treated them unfairly or expropriated their investments, given the risk of conflicts of interest. If investors are given the choice, they prefer depoliticised dispute settlement systems, which can only be offered by neutral tri-

ibunals that are not attached to any particular country. In addition, investors may be more familiar with international arbitration proceedings than with foreign legal systems. The rules governing arbitration are more streamlined, more flexible and less complex than those governing normal legal proceedings.

International arbitration proceedings are generally faster than normal court cases. Arbitrators only deal with one file at a time, while national judges deal with several cases simultaneously. However, arbitration can be more expensive, depending on the cost of filing proceedings in courts in different countries.

Finally, investment agreements with ISDS mechanisms indicate that signatory countries are committed to guaranteeing a stable and predictable environment for investors. BITs with ISDS mechanisms aim to prevent states from breaching commitments under these agreements. They aim to provide a legal mechanism that helps stabilise relationships between investors and the state. Many commentators have compared ISDS mechanisms to an international court that has no enforcement powers but can exercise judicial control over government actions.

2.4. The influence of ISDS mechanisms on investors' strategic decisions

Many countries see BITs as strategic instruments that help attract or encourage foreign investment. Would including an ISDS mechanism in the TTIP help increase FDI flows between the two parties? This question touches on the wider debate as to the *sui generis* ability of ISDS mechanisms to encourage macroeconomic wealth creation.

An economy's attractiveness for foreign investors depends on several factors that include but are not limited to FDI protection rules.²¹ Neither UNCTAD nor researchers – who also underline the difficulty of econometric calculations in this field – have managed to establish a clear statistical relationship linking BITs and increased FDI.²²

“THERE IS NO CLEAR STATISTICAL RELATIONSHIP LINKING BITS AND INCREASED FDI”

Despite the lack of BITs with ISDS clauses between the US and most EU member states, there are considerable FDI flows between the two regions. Furthermore, the nine member states that have signed BITs with ISDS clauses with the US only represent 1% of the US's FDI stock in the EU and 0.1% of the EU's FDI stock in the US.

Care must therefore be taken when asserting that the lack of an ISDS mechanism between the US and the EU would divert FDI to more attractive third countries.

Given the different measures taken by states to create positive investment conditions, it has not yet been clearly proven that ISDS mechanisms play a decisive role in investors' strategic decision-making. Despite media coverage of ISDS mechanisms, multinational corporations often overlook international arbitration in their legal arsenals.²³ Many non-legal considerations, including commercial and tax considerations, play important roles in their strategic investment decisions.²⁴ Other investors' positive and negative past experiences in some countries may also influence their decisions.

2.5. Arbitral tribunals under fire: an illegitimate mechanism

Foreign investors can lay complaints against governments and attack laws, regulations and policy changes that harm their financial interests under the four general principles mentioned above. However, arbitral tribunals can only award financial compensation to investors whose complaints are upheld. They cannot demand that states withdraw or amend decisions or laws breaching agreements. Nor can they impinge upon a state's sovereign right to regulate.

“THE RIGHT TO REGULATE HAS BEEN UPHELD BY ARBITRAL AWARDS”

The right to regulate has been written into recent investment treaties and upheld by arbitral awards. In *Chemtura v. Canada*, the American pesticide company Chemtura used the NAFTA's ISDS mechanism to challenge new regulations prohibiting the use of some pesticides it produced. The arbitral tribunal upheld the Canadian government's sovereign right to legislate based on scientific reviews in the environmental regulation field and dismissed all the investor's claims.²⁵

However, the risk of being required to pay financial compensation can lead some governments to withdraw or modify laws, decisions and regulations. For critics of ISDS mechanisms, this “regulatory chill” is evidence of the indirect influence of foreign investment on legislation. New Zealand, for instance, has suspended its decision to change the law on cigarette packets until a decision has been reached in Philip Morris's complaint against the Australian government resulting from a similar law change.²⁶

Defenders of ISDS mechanisms consider that investors' use of international arbitration to force/modify/influence states' executive, legislative and judicial decisions has been exaggerated. They also underline that

21. Inexpensive labour, natural resources, qualified labour, large and expanding local markets, stable political and economic systems, etc.

22. Tobin, Jennifer & Susan Rose-Ackerman, “Foreign Direct Investment and the Business Environment in Developing Countries: the impact of bilateral investment treaties”, Yale Law School Center for Law, Economics and Public Policy Research Paper No.293, Yale University, New Haven, CT, 2005; Jason Webb Yackee, “Bilateral Investment Treaties, Credible Commitment, and the rule of (international) Law: Do BITs Promote Foreign Direct Investment?”, *Law and society review*, Vol. 42, No. 4, 2008; Susan D: Franck, “The Legitimacy crisis in Investment Treaty Arbitration: Privatizing Public International Law Through Inconsistent Decisions”, *Fordham Law Review*, 1521 2004-2005.

23. Freyer, D. H., et al., “Arbitration under Bilateral Investment Treaties: An often overlooked tool”, *Mealy's International Arbitration Report*, May 1998.

24. Jason Webb Yackee, “Bilateral Investment treaties, Credible Commitment, and the Rule of (international) Law: Do BITs Promote Foreign Direct Investment?”, *42 Law & Society Rev.* 805, 2008.

25. <http://italaw.com/documents/ChemturaAward.pdf>

26. Lauge N. Skovgaard Poulsen & al., “Costs and benefits of an EU-USA investment protection treaty”, *LSE Enterprise*, April 2013, p.39.

arbitration awards have more often been in favour of states than investors. According to UN statistics, the majority of the 274 final awards made following the 568 known complaints have favoured states: 43% of complaints have resulted in favourable decisions for host countries, 31% have resulted in favourable decisions for investors, and 26% have been resolved amicably (no further details are available for these settlements, which remain confidential).

ISDS supporters also highlight that investors do not take decisions to lay complaints against states lightly. Investors know that states defend their positions vigorously and have nearly infinite financial resources, unlike the investors themselves, who take major financial risks given that they may have to pay costs under the final judgment. Investors are also aware that attacking a state as a last resort may worsen an already difficult state-investor relationship, which creates risks for future operations.

2.6. Are ISDS mechanisms necessary between developed countries?

Those who oppose the inclusion of an ISDS mechanism in the TTIP can be divided into two groups: those who consider the mechanism illegitimate, and those who consider it pointless.

There may indeed be a risk that proceedings in some developing countries are politicised due to insufficiently robust or corrupt legal systems. However, this risk is unlikely in American and European democracies. A large number of countries, including the US and EU member states, have already adopted domestic laws protecting against direct and indirect expropriation. Why then rely on international arbitration?

In 2004, Australia successfully negotiated against including an ISDS clause in its trade agreement with the US on the basis that "both countries have robust, developed legal systems for resolving disputes between foreign investors and government." Similarly, in May 2013, the European Parliament unanimously voted to expressly state that future investment agreements would only include ISDS clauses in situations where this would be justified.²⁷

“ALTERNATIVES ARE
CONCILIATION, MEDIATION,
ENFORCEABLE INVESTOR-
STATE DISPUTE SETTLEMENT,
DIPLOMATIC PROTECTION,
PRIVATE INSURANCE POLICIES...”

ISDS opponents underline that investors have a wide range of dispute resolution options available to them as substitutes for or in addition to ISDS mechanisms. Before taking cases to national courts, investors can for example begin conciliation or mediation. Enforceable investor-state dispute settlement is an alternative – as is the diplomatic protection offered by home countries defending investors in host countries by calling on international courts.

Investors can protect themselves against political risks by taking out private insurance policies, which have the advantage of paying out guaranteed compensation independently of host countries' willingness or not to cover damages. Investors can also call on international institutions such as the Multilateral Investment Guarantee Agency (MIGA) or national public bodies to finance proceedings.

In addition, ISDS can lead to undesirable situations such as those experienced when creating the Single Market, including reverse discrimination. In other words, American investors would have the right to begin international arbitration proceedings while European investors were limited to filing cases with national courts; and vice versa.

Another issue that arises as a result of the fragmented nature of BITs around the world is that a company whose home country does not have an investment agreement with the host country may be tempted to buy a company or increase activities in a third country that does have a BIT with the host country, in order to benefit from the legal protection offered by this BIT. In the case opposing Philip Morris and the Australian government, the multinational was accused of buying up its Hong Kong subsidiary to attack the Australian

27. European Parliament resolution of 23 May 2013 on EU trade and investment negotiations with the United States of America.

government under the Hong Kong-Australia bilateral treaty's ISDS clause, given the absence of any bilateral treaty between Australia and the US. The EU and Canada took steps to avoid this "treaty shopping" by setting out in the CETA the trade conditions under which investors may lay complaints.

Finally, ISDS critics consider that delegating authority to a transnational tribunal comes at a political cost.

The internationalisation of justice is not in itself a new occurrence. The International Court of Justice, the Court of Justice of the European Union and international disciplines all play a role in limiting national sovereignty. While the externalisation of legal systems and the reduced competences of nation-states are well established phenomena (reinforced by globalisation), the real moral and political issue is determining what restrictions on sovereignty are acceptable and why and to whom state functions should be delegated.

“ A RISK OF
PRIVATISING
INTERNATIONAL
PUBLIC LAW”

International arbitral tribunals therefore find themselves accused of privatising international public law.²⁸ As underlined by Simon Lester, “you should be aware of the implications of giving power to international courts. There are times when it may make sense to do so, but we need to think carefully about it. What is the scope of this power? What obligations have been created? Who has access to this appeals court? How enforceable are the obligations? What is the design of the system?”²⁹

2.7. Transparency issues

Up until now, arbitral investment proceedings have been based on a commercial arbitration model that requires a certain degree of confidentiality. Too much transparency could have major political implications, because it would increase media coverage of the most controversial cases.

However, ISDS differs from commercial dispute resolution because of its hybrid public/private nature. ISDS involves sovereign states that have obligations of transparency to their citizens. Consequently, NGOs and civil society representatives who oppose ISDS underline the opaque nature of arbitral proceedings, which take place behind closed doors and provide little information to the public. Documents are generally confidential and the public cannot attend hearings. In some cases, the public is not even informed of proceedings.

This criticism of the transparency of arbitral proceedings overlooks the fact that, even in some advanced democracies, national courts can be just as opaque as arbitral tribunals. However, civil societies are increasingly demanding with respect to transparency. More transparent systems, offering a safer and more predictable framework, would increase the legitimacy of arbitral proceedings.

“ THE EUROPEAN
COMMISSION INTRODUCED
A FULL TRANSPARENCY
CLAUSE IN THE CETA'S ISDS”

In the mid 2000s, the US and Canada took an important step forward by introducing more stringent transparency requirements in their investment agreement models.³⁰ The European Commission also attempted to improve its ISDS model during negotiations with Canada and Singapore by introducing a full transparency clause (public access to hearings and documents, the possibility of third-party submissions, etc.)

2.8. The choice of arbitrators

The main reason for using arbitral tribunals is to ensure legal proceedings are independent, impartial and depoliticised. The effective independence and impartiality of arbitrators is therefore a key issue.

28. Susan D. Franck, “The Legitimacy crisis in Investment Treaty Arbitration: Privatizing Public International Law Through Inconsistent Decisions”, *Fordham Law Review*, 1521, 2005.

29. Simon Lester, “The Sad State of the Investor-State Debate”, *Huffington Post*, 22 October 2014.

30. Susan D. Franck, *Ibid.*, 2005.

In the absence of any rules or code of ethics that apply to all arbitrators, the ICSID Convention sets out standards for selecting arbitration panel members (who are lawyers from large law firms or professors specialising in international arbitration). Parties' law firms are charged with selecting two arbitrators from a list supplied by the reference institution. Law firms specialising in international arbitration thus have considerable influence over the selection of panel members, and may suggest arbitrators who are more disposed to hear their clients' cases favourably.

According to internationally accepted rules of conduct, like those adopted by the International Bar Association (IBA), arbitrators must disclose any direct or indirect personal interest in the outcome of arbitration proceedings, and must mention any professional experience or personal relationships that could cast doubt upon their impartiality. However, there is no system that effectively checks this impartiality, apart from the parties themselves who verify that none of the arbitrators selected have conflicts of interest.

Furthermore, the international arbitration community being relatively small, the same people can be called on to be members of an arbitration panel or to act as lawyers for one of the parties involved. This has the potential to create conflicts of interest.

The procedure for paying arbitrators who sit on WTO panels guarantees a certain degree of independence in this respect, as members who sit on the Appellate Body are paid directly out of the WTO budget (financed by member states) and do not receive payment from parties. In international arbitration proceedings, arbitrators are paid directly by parties.

2.9. Access to arbitral tribunals: for multinationals or SMEs?

Another issue is access to arbitral tribunals. Does ISDS benefit multinationals to the detriment of SMEs?

For companies, the cost of proceedings is generally extremely high (the OECD has estimated the average cost of proceedings at USD\$8 million, and some cases can cost up to USD\$30 million³¹). This could prevent some small and medium-sized enterprises from accessing justice. It also reinforces civil society's widely held view that ISDS is an instrument only used by large multinationals.

However, according to OECD estimates, 22% of investors who lay complaints against states under ICSID or UNCITRAL rules are either individuals or very small enterprises with extremely limited international activities (one or two projects).

Medium-sized and large multinationals (with between 500 and tens of thousands of staff) represent just half of the investors who lay complaints. Very large multinationals appearing in UNCTAD's list of the 100 largest transnational corporations only lay 8% of complaints.

2.10. Compensation costs

Some arbitration proceedings have led to compensation payouts amounting to hundreds of millions or even billions of dollars. The Occidental Petroleum Company won an award of USD\$2.3 billion after the Ecuadorian government ended its contract exploiting the country's oil. More recently, in 2014, an arbitration panel awarded the company Yukos compensation of USD\$50 billion against the Russian Federation.

Compensation payouts in arbitration proceedings involving EU member states or the US have been high. In EU member states, they have ranged from USD\$0.46 million to USD\$800 million. In the US, they have ranged from USD\$0.5 million to USD\$1.8 billion.

31. OECD, *Investor-State Dispute Settlement*, Public Consultation Document: 16 May – 9 July 2012, p. 18.

“ THE AVERAGE AMOUNT
OF COMPENSATION
AWARDED WAS
USD\$10.4 MILLION ”

The focus on these record compensation payouts deflects attention from more representative statistical approaches. An empirical investigation of 44 arbitration cases completed by Susan D. Franck in 2008 pointed to a considerable gap between compensation requested and compensation awarded. While compensation requests can reach an average of USD\$343.5 million, the average amount of compensation awarded was USD\$10.4 million.³²

Furthermore, the Treaty of Lisbon raises the issue of sharing the financial burden of arbitration. The EU is a multilevel structure: it has exclusive competence in some areas, and shares competences with member states in other areas. If a complaint concerns European regulations – including the transposal of a European directive into a member state’s domestic legislation – or unfair treatment by a European institution or body, compensation payments should be financed by the EU budget. If, however, a member state is at fault, it must pay all compensation. Nevertheless, regulations on shared competences can be a source of tension between the EU and member states.

2.11. Developing alternatives or adjusting the model?

As seen above, the debate on including an ISDS clause in the TTIP touches on several issues, including guarantees of state sovereignty, the transparency of the mechanism, concerns regarding the selection and code of conduct of arbitrators, and vague legal language used in member states’ BIT models.³³

Investors justifiably demand a safe and predictable legal framework that protects their foreign activities. The debate also has a geostrategic scope, because it concerns the EU’s ability to promote a global ISDS standard in line with European interests.

Those who can see no way out of this situation argue in favour of alternatives (private insurance, mediation, investor-state contracts, bilateral arbitration between states, international courts, etc.) and, with respect to the TTIP, national courts, which they consider impartial.

“ FINDING A BETTER
BALANCE BETWEEN THE
RIGHT OF STATES TO
REGULATE AND THE NEED
TO PROTECT INVESTORS ”

Up until now, the European Commission has adopted a different position. It considers it necessary to establish a European BIT model – which the EU lacks. Acknowledging the shortfalls of the different ISDS models used by member states, it underlines that “(...) the system needs improvements. These relate to finding a better balance between the right of states to regulate and the need to protect investors, as well as to making sure the arbitration system itself is above reproach e.g. transparency, arbitrator appointments and costs of the proceedings.”

The BIT negotiated with Canada – sometimes considered a draft of plans for the TTIP – bears a strong resemblance to the treaty proposed by the US in 2012 (despite a few technical differences). Compared to EU member states’ classic BIT models – generally less than ten pages long and fairly vague – the new generation BIT model in the CETA agreement is more comprehensive and detailed. It resolves issues identified in previous models: it contains more precise legal definitions (on investment types, direct and indirect expropriation, fair and equitable treatment, etc.) to minimise lawyers’ ability to abuse the system by declaring government rules inconsistent with international law.

32. Franck, Susan D. “Empirically Evaluating Claims about Investment Treaty Arbitration”, *North Carolina Law Review*, Vol.86. 2007, pp.57-59.

33. Vaguely defined terms such as “non-discrimination”, “indirect expropriation” and “fair and equitable treatment” give judges considerable leeway and encourage law firms to file trivial complaints, feeding criticism of the expansion of the international arbitration industry.

However, the precisions included in the CETA's ISDS clause still contain terms that give judges considerable leeway. This is the case for indirect expropriation, for example.³⁴

The CETA also makes progress by introducing full transparency at different stages of the arbitration process, binding rules on arbitrators' code of conduct and clarification of social and environmental clauses.

CONCLUSION

While the most recent investor-state dispute settlement (ISDS) mechanism model - laid out in the CETA and EU-Singapore agreements - has made real progress, it remains to be seen whether it will resolve all issues raised.

Given discussions with civil society and growing opposition to these measures, the focus must be on finding the right balance between the legal and economical advantages of including an ISDS clause in the TTIP and the political cost of this decision.

The new Commissioner for Trade, Cecilia Malmström, has adopted a more nuanced position than her predecessor with respect to ISDS. She defends the interest of a more robust and balanced ISDS model, but wanted to wait for the results of the public consultation before deciding on whether to include this mechanism in the TTIP negotiations, in order to evaluate the risks and repercussions of the ISDS debate on the wider agreement negotiated with the US.

34. Annex X.11 of the CETA: "indirect expropriation occurs where a measure or series of measures of a Party has an effect equivalent to direct expropriation, in that it substantially deprives the investor of the fundamental attributes of property in its investment, including the right to use, enjoy and dispose of its investment, without formal transfer of title or outright seizure"; "For greater certainty, except in the rare circumstance where the impact of the measure or series of measures is so severe in light of its purpose that it appears manifestly excessive, non-discriminatory measures of a Party that are designed and applied to protect legitimate public welfare objectives, such as health, safety and the environment, do not constitute indirect expropriations".

ANNEX: EXTRACT OF THE NEGOTIATING MANDATE FOR THE TTIP GIVEN TO THE EUROPEAN COMMISSION CONCERNING INVESTMENT PROTECTION

"The aim of negotiations on investment will be to negotiate investment liberalisation and protection provisions including areas of mixed competence, such as portfolio investment, property and expropriation aspects, on the basis of the highest levels of liberalisation and highest standards of protection that both Parties have negotiated to date. After prior consultation with member States and in accordance with the EU Treaties the inclusion of investment protection and investor-to-state dispute settlement (ISDS) will depend on whether a satisfactory solution, meeting the EU interests concerning the issues covered by paragraph 23, is achieved. The matter shall also be considered in view of the final balance of the Agreement.

As regards investment protection, the objective of the respective provisions of the Agreement should:

- Provide for the highest possible level of legal protection and certainty for European investors in the US,
- Provide for the promotion of the European standards of protection which should increase Europe's attractiveness as a destination for foreign investment,
- Provide for a level playing field for investors in the US and in the EU,
- Build upon the Member States' experience and best practice regarding their bilateral investment agreements with third countries,
- And should be without prejudice to the right of the EU and the Member States to adopt and enforce, in accordance with their respective competences, measures necessary to pursue legitimate public policy objectives such as social, environmental, security, stability of the financial system, public health and safety in a non-discriminatory manner. The Agreement should respect the policies of the EU and its member States for the promotion and protection of cultural diversity.

Scope: the investment protection chapter of the Agreement should cover a broad range of investors and their investments, intellectual property rights included, whether the investment is made before or after the entry into force of the Agreement.

Standards of treatment: the negotiations should aim to include in particular, but not exclusively, the following standards of treatment and rules:

- a. fair and equitable treatment, including a prohibition of unreasonable, arbitrary or discriminatory measures,
- b. national treatment,
- c. most-favoured nation treatment,
- d. protection against direct and indirect expropriation, including the right to prompt adequate and effective compensation,
- e. full protection and security of investors and investments,
- f. other effective protection provisions, such as an "umbrella clause",
- g. free transfer of funds of capital and payments by investors,
- h. rules concerning subrogation

Enforcement: the Agreement should aim to provide for an effective and state-of-the-art investor-to-state dispute settlement mechanism, providing for transparency, independence of arbitrators and predictability of the Agreement, including through the possibility of binding interpretation of the Agreement by the Parties. State-to-state dispute settlement should be included, but should not interfere with the right of investors to have recourse to the investor-to-state dispute settlement mechanisms. It should provide for investors as wide

a range of arbitration *fora* as is currently available under the Member States' bilateral investment agreements. The investor-to-state dispute settlement mechanism should contain safeguards against manifestly unjustified or frivolous claims. Consideration should be given to the possibility of creating an appellate mechanism applicable to investor-to-state dispute settlement under the Agreement, and to the appropriate relationship between ISDS and domestic remedies.

Relationship with other parts of the Agreement: investment protection provisions should not be linked to the market access commitments on investment taken elsewhere in the agreement. ASDS shall not apply to market access provisions. These market access commitments may include, when necessary, rules prohibiting performance requirements.

All sub-central authorities and entities (such as States or municipalities) should effectively comply with the investment protection chapter of this Agreement."

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