



## Seattle to Brussels Network

### Seattle to Brussels Network refutes European Commission's defense of controversial investor-to-state dispute settlement

Long version

January 2014

*Just before the 2<sup>nd</sup> round of the negotiations on the Transatlantic Trade and Investment Protection agreement (TTIP) between the EU and the US, the European Commission issued two papers to defend its position including on the increasingly controversial investor-state dispute settlement mechanism (ISDS) in TTIP. These papers – a “**Factsheet on Investor-to-State Dispute Settlements**”<sup>1</sup> and a paper entitled “**Incorrect Claims about Investor-to-State Dispute Settlements**”<sup>2</sup> seek to address the mounting concerns among civil society and the wider general public. The Seattle to Brussels Network responds to the arguments and the Commission's proposals to amend the flaws in the ISDS system.*

The Commission justifies ISDS by referring to the legal barriers foreign investors face, but gives no concrete examples. Critique that ISDS subverts democracy by allowing foreign investors to bypass national courts and challenge regulations introduced by sovereign states before ad hoc international tribunals is met with the circular argument that “healthy, vibrant democracies sign into ISDS”.

The EC repeats the argument that ISDS can only order states to pay out compensations, but cannot force public authorities to repeal a specific policy. The Commission chooses to disregard how even the threat of claims from large transnational corporations running into tens if not hundreds of millions of dollars can weigh on public budgets and force policy-makers to reconsider proposed legislation.

However, the Commission could not completely ignore the problems associated with ISDS. It was forced to acknowledge the conflicts of interests in the current system, with

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<sup>1</sup> [http://trade.ec.europa.eu/doclib/docs/2013/october/tradoc\\_151791.pdf](http://trade.ec.europa.eu/doclib/docs/2013/october/tradoc_151791.pdf)

<sup>2</sup> [http://trade.ec.europa.eu/doclib/docs/2013/october/tradoc\\_151790.pdf](http://trade.ec.europa.eu/doclib/docs/2013/october/tradoc_151790.pdf)

arbitrators having a financial incentive to favour foreign investors as the only party that can bring an ISDS claim. It was also forced to recognize how the broad legal phrasing of investment protections gives foreign investors scope to abuse ISDS. Similarly, the Commission has had to admit that there is lack of consistency in the awards, that ISDS is costly and biased in the sense that the system is only open to claims from transnational corporations, that it is non-transparent and that claims may also impact on EU budget.

The Commission states that they are “solving” these problems. The Seattle to Brussels Network refutes the Commission’s claims.

## **Incorrect claims? A closer look at the Commission’s responses to growing concerns regarding Investor-State Dispute Settlement (ISDS)**

While in recent trade negotiations, the EC has been tightening up some of the expansive legal phrasing commonly used in investment chapters, it has yet to develop its announced proposals for rules on mediation and a code of conduct for arbitrators. The basic flaws of the system remain unchanged: ISDS arbitrators remain private lawyers, presiding over cases that only investors can initial; taking broad interpretations of the scope and meaning of the investment agreements; issuing awards against which no appeal is possible. The recently concluded trade and investment agreement with Canada (CETA) introduces a sole arbitrator tribunal which, if anything, serves to make ISDS cheaper and more accessible. The investor bias in the system, the absence of investor obligations (for example in relation to the observance of human rights) and the challenge to democracy remain unaddressed.

**Civil society critique #1: Investor- state dispute settlement subverts democracy by allowing companies to go outside national legal systems.**

**EC response: “Untrue!”**

The EC argues that democracy is not subverted as many ‘healthy, vibrant democracies ‘have signed on to investor state’; relying on national courts to enforce obligations in investment agreement can be hard; those courts might be biased or lack independence; they may not be accessible to foreign investors at all; and countries might not incorporate investment agreement rules into national law.

### **The broader picture:**

The EC appears to be confusing the concepts of democracy and sovereignty.<sup>3</sup> Most international investment agreements do not contain provisions to exhaust local remedies before reverting to international arbitration. National legal (democratic) systems are by definition bypassed when international investors – mostly transnational corporations – are enabled to challenge democratic policies for interfering with their profits before ad hoc and intransparent investment tribunals. That many ‘healthy, vibrant democracies ‘have signed on to investor state’ committed to ISDS does not change this. At the same time, the EC has never substantiated its argument that ISDS is needed as a counterbalance for inaccessible and biased national courts – not even when pressed by the European Parliament. In relation to the necessity of including ISDS in TTIP, the Commission has failed to come up with any evidence of discrimination against foreign firms in US courts. Meanwhile, even insiders agree that ISDS undermines sovereignty. An international arbitrator sums it up nicely: “When I wake up at night and think about arbitration, it never ceases to amaze me that sovereign states have agreed to investment arbitration at all [...] Three private individuals are entrusted with the power to review, without any restriction or appeal procedure, all actions of the government, all decisions of the courts, and all laws and regulations emanating from parliament.”<sup>4</sup>

### **Civil society critique #2: Investor-state dispute settlement gives too many rights to companies.**

#### **EC response: “Wrong!”**

The commission says that rights are restricted to "generally accepted principles of international law," explicitly mentioning protection against discrimination, protection against unlawful expropriation and a requirement to treat investors fairly and equitably.

**The broader picture:** What the Commission fails to mention, is that the standard clauses and definitions in investment treaties - in particular those relating to non-discrimination, compensation in the case of direct or indirect expropriation and fair and equitable treatment standards - have been broadly formulated and interpreted by tribunals in a vague, incoherent and potentially unlimited manner.<sup>5</sup>

Civil society and a growing number of states point out that investment protection

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<sup>3</sup> <http://worldtradelaw.typepad.com/ielpblog/2013/10/the-european-commission-defends-investor-state.html>

<sup>4</sup> Perry, Sebastian (2012) STOCKHOLM: Arbitrator and counsel: the double-hat syndrome, Global Arbitration Review, Volume 7 - Issue 2, 15 March, <http://www.globalarbitrationreview.com/journal/article/30399/stockholm-a...> [7-11-2012].

<sup>5</sup> Bernasconi, N. (2012). Investment treaties and why they matter to sustainable development. International Institute for Sustainable Development

agreements favour foreign investors by giving them access to a parallel and exclusive legal system that is not open to domestic investors and allowing them to refer to the broadly phrased protections mentioned above that in many instances would fail if brought under the domestic legal systems of the countries concerned.

### **Civil society critique #3: Investor - state allows companies to sue just because they might lose profits**

#### **EC response: “Wrong!”**

The Commission argues that a loss of profits resulting from a change of laws is not in itself sufficient to sue a host state and claim damages. A breach of a standard in the investment treaty by the host state is a necessary pre-condition.

**The broader picture:** To the letter the Commission is right, investment agreements do not say “companies can sue governments just because they may lose profits” so that “a loss of profits is in itself not sufficient to sue a host state”. But nevertheless this is what it comes down too. When foreign investors find that government measures or changes of law frustrate their operations, intentions or plans and therefore their expectations about profits, they can invoke the vaguely formulated standards on “fair and equitable treatment” or “indirect expropriation” (or “regulatory taking”) to sue governments even if the government measures or changes of law were undertaken to protect the environment or social or other public interests.

The critique from civil society and several states centres on the broad and vague standards in investment treaties, the incoherence in application of these rules by tribunals and the absence of the appeal mechanism to assess procedural questions. This makes it very difficult for host states and companies to predict their rights and respective obligations with certainty.<sup>6</sup>

As the IISD has noted “the imprecise language has led investment tribunals to reach entirely contradictory interpretations of the same obligations”<sup>7</sup>, so that foregone benefits as a result of government regulation can qualify for compensation. This encourages investors to attempt to present profit losses as an “indirect expropriation” or “unfair treatment”.

### **Civil society critique #4: Investor - state dispute settlement cases take place behind closed doors**

**EC Response:** Yes, this is true and we would like to change it by making submissions public, hearings open, all decisions public and interested parties are able to make their

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<sup>6</sup> [http://www.iisd.org/pdf/2010/eu\\_parliament\\_hearing\\_investment.pdf](http://www.iisd.org/pdf/2010/eu_parliament_hearing_investment.pdf)

<sup>7</sup> Op cit.

views known. The EC has stated it wants more transparency at international level, stressing that “the EU is playing a leading role in the negotiations in the United Nations Commission for International Trade Law (UNCITRAL) where countries are deciding rules on the transparency of international arbitral proceedings.”

### **The broader picture:**

The EC’s commitment to enhance transparency is limited and will continue to allow arbitral tribunals to keep hearings private and withhold information not just to protect the “integrity of the arbitral process” or “confidential business information”, but also for “logistical reasons”;

In addition, the new transparency rules would apply only to cases based on the EU’s future agreements. Secrecy can be maintained in all cases arising from the approximately 1200 EU member states BITS that are currently in force, as EU member states will be allowed to exclude existing agreements from the new UNCITRAL transparency rules.

**Civil society critique #5: Investor- state dispute settlement undermines public choices (e.g. Vattenfall challenging the German moratorium on nuclear power, Philip Morris challenging Australia’s plain packaging regime for cigarettes)**

**EC response:** It is important to note that only well founded cases have a chance of being successful. The fact that a policy has been challenged does not mean that the challenge will be successful. The EU will negotiate in such a way so as to ensure that legislation reflecting legitimate public choices e.g. on the environment, cannot be undermined through investor state dispute settlement. Experience with investor state dispute settlement up until now confirms that tribunals do not consider it appropriate to undermine public choices. The Vattenfall and Philip Morris cases are on-going so it is not possible to know the outcome. It is interesting to note, however, that Australia’s legislation is also being challenged through the World Trade Organisation though this time by other WTO members. Should Australia lose that case at the WTO it would indeed be under an obligation to change its legislation. This could not happen as a result of the investor state dispute settlement. Whatever the outcome of the Philip Morris investor state dispute settlement case, we can be sure that Australia will remain free to maintain its legislation. The same goes for the Vattenfall case and Germany’s ban on nuclear energy.

### **The broader picture:**

Commenting on the Philip Morris investor-state dispute with Australia, the Commission claims that ‘whatever the outcome [...], we can be sure that Australia will remain free to maintain its legislation.’ Yet the Commission ignores the key question: what is the price of this “freedom”? Like many countries that are sued using invest-state dispute settlement, Australia may have to pay millions in compensation to Philip Morris for making a public policy choice to protect the health of its citizens. In reality, therefore, the high cost of compensation for enacting any public policy against the will of corporations undermines the ability of states to make public policy choices.

This limitation of policy space is often termed “regulatory freeze”. International Investment agreements seek to lock in a regulatory *status quo*.<sup>8</sup> Bilateral investment treaties, and other trade and investment agreements such as the Canada-EU or EU-US free trade agreements ensure that any changes in the regulatory framework, whether or not they relate directly to trade and investment, can be subject to challenge by investors who can argue that policy changes violate the right to a stable regulatory environment. Measures such as tax collection, health insurance regulation, water supply and transportation policy have all been subject to successful challenge by investors.<sup>9</sup>

Even when private arbitrators rules in favour of governments, the legal costs of cases can be a considerable burden on states’ budgets. International investment lawyers charge up to US\$3,000 per and private investment law firms are making serious profit at the expense of taxpayers.<sup>10</sup>

Often the threat of a claim against a state means that the state does not proceed with a policy change, and so companies use the investor-state arbitration system to challenge public policies they dislike. Currently, US company Lone Pine Resources is suing Canada for compensation following the province of Quebec’s moratorium on ‘fracking’. This case is a clear indication of how investor-state dispute settlement seeks to undermine public choices and how it could be used to challenge fracking bans and moratoria across Europe under the Transatlantic Trade and Investment Partnership.

Finally, with regard to the Commission’s claim that “the EU will negotiate in such a way so as to ensure that legislation reflecting legitimate public choices e.g. on the environment, cannot be undermined through investor state dispute settlement”, the current texts of the EU-Canada (CETA) agreement show that the provisions introduced there by leaving legal loopholes fall short of this intention.<sup>11</sup>

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<sup>8</sup> Jacob, 2012: 34

<sup>9</sup> IISD, 2012:7.

<sup>10</sup> CEO, 2013: 20

<sup>11</sup> See the Seattle to Brussels Network’s analysis of the CETA texts.

**Civil society critique #6: Investor-state dispute settlement is biased in favour of investors - they can threaten to bring expensive cases against governments and so scare them away from policies that the investors do not like.**

*EC response: The EC states that UN statistics on investor-state-dispute cases show that a majority of cases, around 42%, were decided in the state's favour and 30% in favour of the investor. The rest were settled.*

**The broader picture:**

These statistics do not give the full picture. As Singaporean attorney general Sundaresh Menon observes: It is “in the interest of the entrepreneurial arbitrator to rule expansively on his own jurisdiction and then in favour of the investor on the merits because this increases the prospect of future claims and is thereby business-generating.”

It is also important to recognize that investment arbitration is not just about the final awards. Research by International investment lawyer and trade agreement expert Gus van Harten reveals that arbitral tribunals tend to resolve contested legal issues in investment treaty law with expansive interpretations. These enhance “the compensatory promise of the system for claimants and, in turn, the risk of liability for respondent states”, he writes, adding: “If the system is meant to provide an impartial and independent adjudicative process based on principles of rationality, fairness, and neutrality, then the interpretation and application of the law should reflect a degree of evenness between claimants and respondent states in the resolution of contentious legal issues arising from ambiguous treaty texts.”

Investment arbitration is non-reciprocal. Investors cannot be sued, for example, when they violate human rights. They might not win every case, but only states can lose in the sense that only states have to pay compensation.

In addition, it is likely that many of the settled cases – 30% of known decisions – involve payments or other concessions for the investor. Germany, for example, settled the first dispute with Swedish energy company Vattenfall by agreeing to water down environmental standards imposed on one of Vattenfall's coal-fired power plants. Paper maker Abitibi-Bowater's case against Canada was settled when Canada paid US\$130 million. When settlements contain benefits for the investor, the above statistics look very pro-investor.

Lastly, the threats of claims against governments have become ever more important and occur more frequently than actual claims. There is clear evidence that proposed and even adopted laws on public health and environmental protection have been abandoned or watered down because of the threat of corporate claims for damages. It is also likely that countries are currently postponing and/or weakening anti-smoking legislation because of the Philip Morris claims against Australia and Uruguay. Even if

the tobacco company loses, these cases could have a chilling effect on anti-smoking laws across the world.

By granting them an exclusive right to threaten and initiate claims at international tribunals that regularly order governments to pay large sums in compensation, investor-state arbitration gives investors a privileged position in policy-making and in the allocation of public funds which are used to pay compensation for laws that may benefit a wide range of constituencies. Domestic investors do not have this privilege, let alone citizens and communities. It is difficult to understand how such a system can be presented as not “pro-investor”.

The EC offers the solution that the costs of litigation should be borne by the losing party, which would act as a deterrent for investors to bringing tactical or spurious claims.

But two trends reduce or even remove the financial risk of an expensive claim, making investment disputes more attractive for investors. Firstly, contingency fee arrangements are becoming more and more common in investment arbitration. Secondly, third-party funders are increasingly common, financing (parts of the) costs of investment disputes in the hope of sharing in the spoils if a pay-out is awarded.

While there is usually little incentive for funders to fund weak cases, bubbles in the legal claims market might incite exactly that. Mick Smith from litigation funder Calunius Capital has indicated that is the case: “The perception that you need strong merits is wrong – there’s a price for everything”. Eventually, frivolous, high-risk claims could inflate the value of funders’ portfolios. As the Burford Group, another litigation funder, noted: “If we shy away from risk for fear of loss, as some litigation investors do, we will not maximise the potential performance of this portfolio”.

**Civil society critique #7: Investor- state dispute settlement cases are decided by a small clique of lawyers, with considerable conflicts of interest, who seek to cream off public money.**

**EC response:** The EC states that the number of true specialist lawyers in this field is not large. EC acknowledges that some lawyers indeed do combine roles as arbitrators and advocates and that this crossing over may create the risk of conflict of interest. The EC therefore proposes that in the future the presiding arbitrators will be appointed by agreement of both disputing parties. EC further proposes a code of conduct to prevent conflict of interests.

**The broader picture:** Profiting from Injustice<sup>12</sup>, a report by civil society organisations CEO and TNI on the arbitration industry, finds that the international investment arbitration industry is dominated by a small and tight-knit Northern hemisphere-based community of law firms and elite arbitrators. Three top law firms – Freshfields (UK), White & Case (US) and King & Spalding– claim to have been involved in 130 investment treaty cases in 2011 alone. Just 15 arbitrators, nearly all from Europe, the US or Canada, have decided 55% of all known investment-treaty disputes. This small group of lawyers sits on the same arbitration panels, acts as both arbitrators and counsels and even calls on each other as witnesses in arbitration cases. This has led to growing concerns, including within the broader legal community, over conflicts of interest.

The boom in arbitration has created bonanza profits for investment lawyers paid for by taxpayers. Legal and arbitration costs average over US\$8 million per investor-state dispute, exceeding US\$30 million in some cases. Elite law firms charge as much as US\$1,000 per hour, per lawyer – with whole teams handling cases. Arbitrators also earn hefty salaries, amounting up to almost US\$1 million in one reported case. These costs are paid by taxpayers, including in countries where people do not even have access to basic services.

The report Profiting from Injustice also questions the alleged neutrality of the “elite of 15 investment arbitrators”. Some have explicitly stated “they do not normally see themselves as guardians of the public interest”. Some sit or have sat on corporate boards, including in companies which have filed investor-state disputes. Some have worked or are working for law firms which encourage investors to claim against states and which also advise on picking the most investor-friendly treaties for their claims as well as on structuring their investments accordingly. Others have spoken out against investment treaty revisions which might allow governments greater freedom in policy making. One arbitrator has his own lobby firm advising corporations on how to avoid or counteract government regulations. Yet these elite arbitrators have decided the majority of all known investment-treaty disputes, weighing public interest against the interests of profit (see chapter 4 in our report). These close links with business, combined with their belief in a system that is demonstrably biased in favour of corporations, raises questions about the neutrality of international investment arbitration.

**Civil society critique #8: Investors should not be allowed to challenge governments directly in international law. Only governments should be able to act against each other, via state-to-state dispute settlement.**

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<sup>12</sup> <http://www.tni.org/briefing/profitting-injustice>

**EC response:** It is investors who actually suffer the financial losses. Governments (including the EU) need to pursue the general interest, and that means that they have neither the time nor the resources to follow-up each individual alleged breach of the agreement.

**The broader picture:**

Governments should avoid the inclusion of investor to state dispute settlement (ISDS) provisions in trade and investment agreements. With trade disputes, states rely on state-state settlement. There is no clear reason to treat foreign investment differently.

ISDS enables transnational corporations to bring a case directly against a country hosting its investment, without the intervention of the government of the investor's country of origin. ISDS gives transnational corporations a powerful tool to challenge a wide range of government regulation and public interest measures. Direct access to investment arbitration allows foreign investors to bypass the domestic legal system and effectively grants them more rights than domestic investors. The ISDS system, which lacks independence, accountability, transparency and coherence in law, is unnecessary: Foreign investors do not need a parallel legal system to enforce their superior rights. Even governments with less robust legal systems will generally be keen to maintain a good reputation with foreign investors and refrain from arbitrary expropriations or systematically discriminating against foreign investors.

Through regulatory chill effects and the cost of arbitration and awards, ISDS provisions constitute a considerable and growing policy and financial risk. The exponential growth in the number of ISDS cases spurred on by international trade lawyers; frivolous claims; and pressures to shelve regulation under threat of investment claims are systemic flaws. Political risk insurance constitutes more appropriate mechanism for dealing with political risk than ISDS.

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