POSITION PAPER

2 May 2014

INVESTOR-STATE DISPUTE SETTLEMENT – A NECESSARY MECHANISM TO ENSURE INVESTMENT PROTECTION

KEY MESSAGES

1 **ISDS is a vital part of investment protection.** It provides for a neutral, fact-based mechanism of dispute resolution in cases of breaches of investment agreements. It is important for reasons of substance and consistency that ISDS is included in all EU BITs and FTAs, irrespective of whether counterparts are OECD, emerging or developing economies.

2 Contrary to what is often claimed, **ISDS does not limit the policy space of States**, including in the area of public goods and services. Instead, it helps establish a balance between the right of States to regulate and the rights of investors to protection under international law.

3 **The current ISDS mechanism may be significantly improved.** For instance, it could be more transparent, inclusive and coherent. Further rules may need to be considered to better prevent frivolous claims. European business is ready to engage in discussions to improve ISDS.

WHAT DOES BUSINESSEUROPE AIM FOR?

- *This position paper seeks to explain what "ISDS" is and how it works in practice. It also aims at clarifying misconceptions about ISDS. The paper strongly pleads in favour of its inclusion in all EU BITs and FTAs and proposes ways to improve the mechanism.*

- *Taking on board the criticism that ISDS currently receives, this paper argues that such a mechanism helps in the enforcement of investment agreements – not through compromising the right of the State to regulate, but through providing investors the opportunity to seek justice and get compensation in cases of **illegal** expropriations or discrimination.*

- *It is crucial that ISDS is maintained. It is also important however that it undergoes a review that will effectively address concerns over its claimed shortcomings, such as lack of transparency, legitimacy, coherence or conflicts of interest.*

KEY FACTS AND FIGURES - 2012 – source: UNCTAD

58 new cases were initiated – the highest number ever filled in one year	244 cases were concluded – of which: 42% were decided in favour of the State, 31% in favour of the investor and 27% were settled	In the majority of the cases respondents were developing countries, but the number of cases against developed countries also increased

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This paper describes the general framework of foreign investment and investment protection. It then analyses Investor-State Dispute Settlement (ISDS), explaining why ISDS needs to be included in international investment agreements. It finally discusses possible ways to improve the existing ISDS mechanism.

A NECESSARY MECHANISM TO ENSURE INVESTMENT PROTECTION

General Context

Foreign Direct Investment (FDI) is a driving force for prosperity and growth in industrialised, emerging and developing countries. Companies' investment decisions are however associated with a number of political and economic risks. It is with a view to mitigating these risks that States conclude Bilateral Investment Treaties (BITs).

The negotiation of BITs has been a common practice for EU Member States since the 1960's. However, after the entering into force of the Lisbon Treaty in 2009, the international Investment Policy is an exclusive EU competence. The European Commission is currently negotiating a significant number of BITs and Free Trade Agreements (FTAs), which include investment protection chapters, with trading partners all over the world.

Given the growing volume of global FDI and the multi-polarisation of the globalised economy, effective investment protection is more important than ever. According to UNCTAD, the worldwide stock of FDI has tripled since 2000, and grown more than 11-fold since 1990. In 2012 the global outward stock of FDI amounted to $23.6 trillion. The increase of FDI therefore requires a high-level international protection of investments. Until the Treaty of Lisbon, this level of protection was provided for by agreements that EU Member States concluded bilaterally. It is now the responsibility of the EU to secure such investment protection.

As in most international agreements, BITs and FTA investment chapters include dispute settlement mechanisms, which provide a framework for conflict management. In the case of investments, the typically chosen form of dispute settlement is the Investor-State Dispute Settlement (ISDS).

What is Investor-State Dispute Settlement?

Bilateral Investment Treaties (BITs) or Free Trade Agreements (FTAs) with investment protection provisions are international agreements seeking to promote an open international investment climate, which in turn promotes growth and the creation of jobs. They define the agreed framework in which bilateral investments can take place, the rights and obligations that the signatory parties – namely two States – have under the agreement.

These take the form of principles, including: the Most Favoured Nation (MFN) Treatment, National Treatment, Fair and Equitable Treatment and the guarantee of

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Free Transfer of Capital. These substantive provisions encourage FDI, especially into developing countries, where foreign investors may require additional assurances that they will be treated fairly and equally compared to domestic investors before importing capital in the host country.

Investor-State Dispute Settlement (ISDS) is a mechanism that governments include in most investment protection agreements[1]. Although ISDS is presented as an instrument that creates possibilities for abuse by foreign investors, the purpose of the instrument is to limit possible arbitrary behaviour of governments towards foreign investors[2]. In fact, it helps establish the right balance between the right of the States to regulate and the rights of investors to protection.

ISDS is an instrument that helps in the enforcement of the aforementioned principles, providing investors with adequate protection and compensation, for instance against illegal expropriation and discriminatory treatment. Practically, it allows investors originating in one State, party of the agreement, to bring a direct legal claim before international tribunals against the other State, the host State of the FDI, in cases where the agreement in question has been breached. Thus, ISDS is a means to promote and ensure respect of international law, i.e. the rights and obligations agreed between States in their investment agreements.

An ISDS procedure does not start automatically, as it is not the first step that the parties take when a dispute arises. The majority of the agreements, that include investment protection, call on the investors and host States to first seek for an amicable solution within a specified reasonable period of time before they can resort to international arbitration.

In this context, it is important to note that one third of the disputes are settled before the panel comes to its final conclusion. This underscores that arbitral proceedings provide an effective forum for finding acceptable solutions, without necessarily arriving at the final stage of the procedure, which is the allocation of 'awards' (compensation of damages).

If an amicable solution cannot be found, then the parties may resort to conflict resolution facilities, provided by international institutions which specialise in investment arbitration. The two leading organisations in this field are linked to multilateral intergovernmental organisations: the International Centre for Settlement of Investment Disputes (ICSID), created under the auspices of the World Bank, and the United Nations Commission on International Trade Law (UNCITRAL)[3].

Practically, by agreeing to ISDS a State gives a "standing offer" for arbitration. In other words, the State cannot refuse the legal proceeding if an investor brings a claim against it under the agreement in question. However, the actual ISDS proceedings that

[1] ISDS has been included in all 1400 bilateral agreements signed by EU Member States since the 1960s, while the EU is itself party to the Energy Charter Treaty, which also contains ISDS provisions.
[2] This has regularly occurred in the past; a recent case being the "Repsol/Argentina".
[3] Other international arbitration systems include: the Stockholm Chamber of Commerce (SCC), the International Chamber of Commerce (ICC), the Cairo Regional Centre for International Commercial Arbitration (CRCICA) and the London Court of International Arbitration (LCIA). Variations exist between these systems, each of which follows their own rules and procedures.

follow typically require the full consent of both parties involved. The two parties need to agree on issues in the different stages of the process, including the choice of arbitrators, the way that the different proceedings are conducted and the publication of the award.

Moreover, and dissimilar to State-State Dispute Settlement[4], under no circumstances does a ruling under ISDS require a State to revoke a law, regulation or any other measure, even in cases where the particular law, regulation or measure has been found to violate the bilateral agreement. The ISDS arbitrators only allocate awards.

The award of the tribunal is final and binding. ICSID decisions are automatically recognised and enforceable under the New York Convention for Recognition of Foreign Judgments, while rulings of other international arbitration facilities may need to be recognised and enforced via domestic law. The latter means for example, that a local court decision may be required before the host State recognises and enforces the rendered award. On some occasions however, local courts do not accept the jurisdiction of the tribunal, this resulting in awards not being recognised or enforced, and therefore investors not being compensated.

FOCUS: ISDS and EU Member States

ISDS is not a new concept. EU member states have been including it in their FTAs and BITs since 1959[5] and have extensive experience in investment arbitration, both with developed and developing countries.

EU companies are the most frequent users of ISDS. Out of 514 registered ISDS cases, investors from the Netherlands have initiated 50 cases, followed by 30 from the UK and 27 from Germany[6]. Investors from Italy, France and Spain have also initiated a number of ISDS cases. On the other hand, US companies have launched a total of 123 cases[7].

Following the entering into force of the Lisbon Treaty, the exclusive competence for the Investment Policy lies with the EU – including the mandate to negotiate FTAs and BITs, which task is conferred to the European Commission. ISDS provisions have been already included in the CETA Agreement with Canada and the FTA with Singapore, which are about to be finalised. The Commission is currently negotiating such provisions in a Bilateral Investment Agreement with China as well as in its FTAs with Japan, India, Thailand, Vietnam, Morocco and the TTIP.

Why is the Investor-State Dispute Settlement mechanism necessary?

1. ISDS provides for an international, relatively rapid, fact-based and neutral dispute resolution mechanism. Unfortunately, the reality is that separation of powers and lack of judiciary independence and impartiality is not always evident in some States. In this context, the possibility to resort to ISDS provides an

[4] For instance within the WTO Dispute Settlement system
[5] Germany-Pakistan BIT, signed in 1959 and entered into force in 1962
[6] UNCTAD, "Recent Developments in Investor-State Dispute Settlement (ISDS)", Issues Note No.1, May 2013, p.4
[7] UNCTAD ISDS Database

opportunity to seek for independent and impartial judicial decisions, based on technical and legal grounds.

2. The existence of ISDS encourages governments to respect their international obligations when they regulate and implement policies. All governments operate within an international legal framework which they are obliged to respect and take into account when creating national legislation. The national legal framework should be compatible with the agreed international framework.

   The purpose of the ISDS is not to compromise the policy space of the State-Regulator. It rather guarantees that compensation will be awarded to investors in cases the latter are treated unfairly, are unlawfully expropriated or are discriminated against, in violation of the international treaty.

   Also in the area of public goods, States remain able to adopt measures necessary for the protection of the environment or health. *As long as* these measures are non-discriminatory and compatible with States' international obligations, ISDS is in no way a concern. To the contrary, it is in the interest of all to include ISDS in investment agreements as it provides a mechanism to determine whether measures of States are legitimate or rather a form of disguised protectionism.

   It is established practice in ISDS to reaffirm the States' right to regulate. For instance, the tribunal in the Saluka Investments BV vs The Czech Republic (2006) stated the following:

   "It is now established in international law that States are not liable to pay compensation to a foreign investor when, in normal exercise of their regulatory powers, they adopt in a non-discriminatory manner bona fide regulations that are aimed at the general welfare."

   It is also clear that States must not lower their environmental or labour standards in order to attract investments. Provisions forbidding such practices are already included in BITs and FTAs.

3. Some argue that ISDS discriminates against domestic investors – that are only entitled to use local courts – and favours foreign investors that are offered the possibility to resort to international arbitration against the host State. They therefore support having ISDS at most as the last possible option, available and only after exhaustion of local remedies. However, this is not a reasonable requirement for the following reasons:

   a. This reasoning disregards the essence of why ISDS is created: to protect foreign investors from a biased judgement on the grounds that they are foreign. ISDS is not creating discrimination. It is rather an antidote to discrimination.

   b. Moreover, it is very likely that host States get immunity in local courts, particularly when it comes to public acts. This may lead to partial and inequitable treatment against foreign investors.

c. Bilateral Investment Treaties and Free Trade Agreements are international agreements that fall under public international law and, therefore, should be treated under public international law. Local courts may be prevented from directly applying international law. Thus, ISDS can be the only means to have possible breaches of international law scrutinised.

4. Finally, ISDS helps de-politicise investment disputes, promoting their more objective and effective treatment. By allowing investors their own right of action, ISDS alleviates the pressure States may feel in situations where they would have to defend the interests of one investor against another State, and bear not only the political but also the financial cost of a case.

FOCUS: Why ISDS is especially needed in TTIP?

In the previous paragraphs it was shown that ISDS is an effective mechanism for investment protection, promoting open international flows of investment, leading to fair conflict resolution and respecting the legitimate policy freedom of host States. ISDS is normally a part of BITs and investment chapters of FTAs, there is therefore in principle no reason not to include ISDS also in TTIP. Furthermore:

1. **It has become clear in recent years that ISDS is also necessary between OECD economies.** Both the US and the EU are members of the OECD and have sound legal systems, under which the rights of foreign and domestic investors are generally protected. This does not remove the need for ISDS. For instance, between 2008 and 2012 there were 113 cases initiated by EU investors, 27% of which were intra-EU cases (19 cases) or based on the Energy Charter Treaty (12). Of 28 EU Member States, 21 are also members of the OECD and of 52[8] Energy Charter Conference members, 27 are also members of the OECD.

2. **Foreign investors may not in all cases receive adequate protection in US courts**[9]. To offer an example, if a domestic US law is adopted after TTIP enters into force and its content violates the agreement, such a law can still be found constitutional. In this case, the only possibility for a European investor to seek the protection agreed in TTIP is to bring the claim to international arbitration.

3. Including ISDS in TTIP will not unduly limit the policy space of the EU. The US has included ISDS in most of its investment agreements, including those concluded with EU Member States, prior to the entering into force of the Lisbon Treaty. **Not including ISDS in TTIP would be weakening the standards that currently apply.** Moreover, there has been no evidence whatsoever of a "regulatory chill", or hesitation to pass new environmental and health regulations in these countries as a result of these agreements.

4. Concerns have been raised that TTIP may lead to the launch of numerous claims by US companies against EU Member States. Nevertheless, US

[8] The total number of Energy Charter Conference members is 54 when European Communities and Euratom are included.
[9] The right of non-discrimination is absent from the domestic U.S. legal system, unless there is an international agreement.

companies could have already done this under the current agreements between the US and EU Member States. This is not however the case.

5. Furthermore, the EU and the US are equally strong trade and economic partners. Therefore, the ISDS mechanism negotiated in the context of TTIP would be a balanced, modern, comprehensive and state-of-the-art dispute settlement mechanism, which could set high international standards for future agreements.

6. Finally, it would seem inconsistent, arbitrary, unjustified and unreliable from the part of the EU to view ISDS as a central element in an investment treaty with emerging and developing countries while insisting on not having such a mechanism in a treaty with OECD members. Such a precedent would weaken the ability of the EU to include ISDS in future BITs and FTAs with non-OECD countries, for instance with BRICS.

How can the existing system be improved?

BUSINESSEUROPE is open to discuss on the basis of well-founded criticism on ISDS and willing to contribute with concrete proposals on how the existing mechanism can be improved. The overriding aim is to strike a balance between adequate protection of foreign investors and the right of States to regulate.

It should be noted that the EU is a world centre for international commercial dispute resolution, and any action in this area should be multilateral, with organisations such as UNCITRAL involved heavily in the process.

Transparency

Currently, only the awards rendered by ICSID tribunals may be publicly available. It is to the discretion of the parties to make this information public. Certainly, sensitive information revealed during the legal process should not be publically disclosed, to avoid revealing trade secrets or undermining the competitive position of the company involved. However, ISDS procedure could be generally made more open. For instance, hearings could be more open to the participation of stakeholders which could also be allowed to make expert submissions.

As of April 2014, the new UNCITRAL Transparency Rules are in force. We expect this to significantly contribute to increased transparency in the arbitration processes based on UNCITRAL rules.

Arbitrators

Questions have been raised on the independence and objectivity of the procedures to select arbitrators and the arbitration as such. The European Commission has recently proposed the adoption of a “Code of Conduct” for arbitrators. BUSINESSEUROPE in principle supports the idea that arbitrators are qualified and impartial and awaits further information on the content of the proposal.

Precise definitions of key concepts

A large number of ISDS cases claim breach of agreement based on lack of fair and equitable treatment or indirect expropriation. These terms should be more clearly defined. A better understanding of the rights and obligations of the parties could be beneficial and contribute to preventing the initiation of cases with no legal merit.

Frivolous claims

It is important that measures to prevent investors from launching frivolous claims are also taken. Options to consider include a more thorough review of claims before proceeding to the arbitration phase. Also, the extent of acceptable "treaty shopping" and further measures to avoid parallel claims could be considered. The introduction of the "loser pays" principle may also discourage frivolous claimants.

Appeal mechanism

The possibility to introduce an "appeal mechanism" in ISDS should be explored. As explained above, the rulings of ISDS tribunals are final and binding. Subjecting the awards to an appeal mechanism could, for example, help tackle problems of misinterpretations of agreement provisions and increase the coherence and overall credibility of the system.

For a possible appeal mechanism to be effective, the creation of such a mechanism should be explored at multilateral level, rather than at bilateral level. Discussions on the topic should be encouraged both in the World Bank[10] and in the OECD fora.

Improvement of timing and enforcement

Although ISDS is a relatively rapid procedure, there is room for improvement. For instance, the time limits for passing from one stage of the procedure to the next could be shortened.

The track of ISDS award enforcement is overall positive. There are cases however that suffer from complete lack of enforcement. Measures to improve recognition and enforcement of awards should be taken at multilateral level, for instance in the framework of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the "New York Convention").

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[10] Such an appeal mechanism does not exist under ICSID. There is however an annulment procedure, which is used in cases where the arbitration process was not conducted according to the ICSID rules.