

ISDS: A rigged system, avoid lock-in

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draft version 25th June 2014
For updates see <http://acta.ffi.org/?p=2118>

This note is an attachment to the FFII submission to the EU commission's consultation on investor-to-state dispute settlement (ISDS). (Commission, 2014a)

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Summary

This note concludes that investor-to-state dispute settlement lacks conventional institutional safeguards for independence and has characteristics of a rigged system. The appointment of arbitrators is not neutral and gives the US an unfair advantage. The US never lost an ISDS case, we can not expect European companies to win major ISDS cases against the US, all the more as the US is not shy to exert pressure on arbitrators. We can expect that US companies will win ISDS cases against the EU and member states. This leads to four considerations.

First, ISDS arbitrators will be able to review all decisions of governments, legislators and courts, including the European Court of Human Rights, and they can award unlimited damages. The European Commission aims to add ISDS to trade agreements from which it is near impossible to withdraw. Given that ISDS lacks conventional institutional safeguards for independence, does not observe the separation of powers, has characteristics of a rigged system and gives the US an unfair advantage, the transfer vast powers to arbitrators

without possibility of withdrawal would be imprudent. At the very least, to protect its future, the EU has to avoid a lock-in, should not deviate from standing European practice of stand-alone investment agreements. The EU should not add ISDS to trade agreements.

Second, the EU aims to create a global standard. Presently a minority of foreign investments is covered by ISDS, after ISDS agreements between the major capital exporting countries a large majority of global foreign investments would be covered by ISDS. Wide coverage of global foreign investments and impossibility to withdraw would create a near global lock-in. Given that the commission's reforms fail on many counts, a near global lock-in would give arbitrators unprecedented and unchecked powers. This would burden democracies, local companies, tax payers, human rights and the rule of law.

Third, quintessentially, states need a margin of appreciation. States which are constantly battered by threats and legal challenges can not function properly, can not take decisive action. The US protect themselves through a system rigged to their advantage. It is an existential threat to the EU not to be able to take decisive action, especially since the US can. Raison d'état necessitates to avoid this situation.

Fourth, foundationally, an essential aspect of liberalism is constitutional liberalism – the separation of powers, the creation of strong institutions. Sovereign decisional power accompanied by strong institutions can provide fairness. ISDS undermines the institutions. ISDS undermines the EU's vital interests and values, it has to be rejected. In doing so, the EU would give direction to the debate and create room to strengthen alternatives.

Investment agreements with ISDS give foreign investors, usually multinationals, the right to circumvent national courts and challenge decisions of states for international investment tribunals if decisions may lead to lower profits than expected. Multinationals can challenge reform of copyright and patent law, challenge privacy measures, challenge environmental and health policies. For an introduction see Stiglitz (2013) or Vrijschrift (2014). The number of ISDS cases is rising, foreign investors are increasingly resorting to ISDS. (UNCTAD, 2013)

This note is divided into three sections. The first section analyses procedural issues with the ISDS system. Adjudicative processes have to be free of reasonably perceived bias. The section argues that this is not the case with ISDS. The ISDS system gives great power to arbitrators, but lacks conventional institutional safeguards for independence: tenure, prohibitions on outside remuneration by the arbitrator and neutral appointment of arbitra-

tors. Arbitrators are paid for their task at least 3000 US dollar a day. This for-profit system creates perverse incentives: accepting frivolous cases, letting cases drag on, letting the only party that can initiate cases win to stimulate more cases, pleasing the officials who can appoint arbitrators.

The appointment of arbitrators is not neutral, it gives the US an unfair advantage. The section concludes that the system has characteristics of a rigged system. We can not expect European companies to win ISDS cases against the US, all the more as the US is not shy to exert pressure on arbitrators.

The section observes that the system is unfair, it gives highly-actionable rights to foreign investors but without any correspondingly actionable responsibilities, and it does not provide standing to people whose rights may be affected by the outcome of the case.

The second section discusses the commission's reforms. It concludes that the commission did not solve the procedural issues mentioned above.

Regarding substantive investment protection provisions this section concludes that contrary to commission statements, the known Most Favoured Nation loophole still exists. Companies will not only be able to use the substantive investment protection provisions in TTIP, but they can cherry-pick from any other investment agreement the EU or EU member state signed. The text creates supreme investors rights which trump human rights. There is no general exception that safeguards the right to regulate. Specific limitations to safeguard the right to regulate are limited and do not solve the kind of uncertainty the EU is trying to avoid.

The third section argues that the commission's proposals are fundamentally incompatible with Europe's human rights system. It concludes that ISDS threatens our privacy and reform of copyright and patent law. ISDS creates a higher chance on compromising the stability and integrity of the financial system. The filter mechanism proposed by the commission has a very limited scope, is dependent on other parties, doesn't help against the chilling effect of threats and even creates perverse incentives. This section also concludes there is a lack of necessity for ISDS.

1 A rigged system

This section discusses procedural issues with the ISDS system.

1.1 Lack of conventional institutional safeguards for independence

Adjudicative systems have a single point of failure: judges have discretion. Appeal has to be possible and the highest instance has to be surrounded by the highest possible institutional safeguards for independence. Actual bias is hard or impossible to prove, adjudicative processes have to be free of reasonably perceived bias.

Arbitrators have great power, this power is not surrounded by conventional institutional safeguards for independence: tenure, prohibitions on outside remuneration by the arbitrator and neutral appointment of arbitrators.

Arbitrators are paid for their task at least 3000 US dollar a day. This for-profit system creates perverse incentives: accepting frivolous cases, letting cases drag on, letting the only party that can initiate cases win to stimulate more cases, pleasing the officials who can appoint arbitrators.

1.2 No neutral appointment of arbitrators

The appointment of arbitrators is not neutral. One arbitrator is appointed by each of the disputing parties. In courts it is not possible to bring your own judge. The third arbitrator, the presiding arbitrator, is appointed by agreement of the disputing parties. The claimants have a 50% influence on the make-up of the tribunals. And that is not all.

The US appoints the president of the World Bank. This president

- is ex officio chairman of the International Centre for Settlement of Investment Disputes (ICSID) Administrative Council,
- proposes the ICSID secretary-general,
- appoints all three the arbitrators in appeal cases under ICSID rules.

The secretary-general of ICSID

- appoints the third arbitrator if the parties can not agree on the third one,
- will decide on conflicts of interest. (ICSID, articles 5, 10, 38, 52 and Commission, 2014b, Table 8, article x-25.10)

Executive officials have influence on the appointment of arbitrators, the system does not observe the separation of powers. Moreover, these executive officials have a link with the US.

The ISDS system lacks conventional institutional safeguards for independence (above, Section 1.1), the arbitrators have perverse incentives, the appointment of arbitrators is not neutral, and it gives the US an unfair advantage.

Adjudicative processes have to be free of reasonably perceived bias. This is not the case with ISDS. The system is flawed, ISDS has characteristics of a rigged system.

1.3 Statistically significant evidence

There may be more than a reasonably perceived bias, a study suggests there may be actual bias. The study “examines trends in legal interpretation instead of case outcomes and finds statistically significant evidence that arbitrators favour: (1) the position of claimants over respondent states and (2) the position of claimants from major Western capital-exporting states over claimants from other states.”

The study finds that claimants from the US were 91% more likely to benefit from an expansive resolution than claimants from all other states combined. Claimants from Western European former colonial powers were 75% more likely to benefit from an expansive resolution than claimants from all other states combined, other than the US.

The study concludes: “These tendencies, especially in combination, give tentative cause for concern and provide a basis for further study and reflection on the system’s design, not least because the use of investment treaty arbitration appears to be a relatively recent phenomenon.” (Van Harten, 2012)

These are sensitive issues. Expansive interpretations put pressure on the public interest. Furthermore, if ISDS amounts to a neo-colonialist instrument, that would not be compatible with the EU treaties (TEU articles 3.5 and 21).

1.4 The US never lost an ISDS case

The US never lost a known ISDS case. The US could have lost the Loewen ISDS case, as the national court took a terrible decision. The US won the Loewen ISDS case on a technicality.

After the Loewen ISDS case one of the tribunal members publicly conceded having met with officials of the US Department of Justice (DoJ) prior to accepting his appointment. The DoJ put pressure on him. (Kleinheisterkamp, 2014)

The ISDS system gives the US an unfair advantage. The US is not shy to exert pressure on arbitrators. We can not expect European companies to win (major) cases against the US.

Who appoints the president of the World Bank may change in the future, but from a European perspective the situation will not have improved if for instance China manages to get its candidate appointed as president of the World Bank.

1.5 Unfairness

The ISDS system is unfair. People whose rights may be affected by the outcome of cases have no standing. The parties in the conflict can present facts and arguments in absence of other affected parties.

ISDS does not provide balance. It gives highly-actionable rights to foreign investors but without any correspondingly actionable responsibilities. ISDS disciplines states but not foreign investors.

Foreign investors gain competitive advantages. Damages may include full compensation, including lost expected profits and interest. The high damages give a bargaining advantage in relations with legislatures, governments, or courts. The high damages have a chilling effect.

1.6 Human rights

The European Court of Human Rights can review decisions of national courts. This ensures compliance with human rights. Arbitrators will be able to review decisions of the European Court of Human Rights. This en-

sure compliance with investors' rights, but creates a serious risk for human rights.

1.7 Questions of law

In ISDS systems questions of law are not decided by a court. In commercial arbitration a party can appeal to a court for questions of law. This is not possible in ISDS cases. In ISDS cases arbitrators working in a for-profit system are the final interpreters of the investment protection rules. Arbitrators tend to be expansive in their interpretations.

1.8 No legislative feedback loop

The ISDS system does not have a legislative feedback loop. In democracies the legislator makes the law and courts interpret it. If the end result (the case law) is not satisfying, the legislator can amend the law. Over time, societies can find a fair balance. Societies have a legislative feedback loop, although it may be called "crude, sluggish, and under-inclusive" (Rens, A, 2012). Arbitrators tend to be expansive in their interpretations, legal reasoning may go awry. A legislative feedback loop is essential. For instance, the Netherlands abolished its suffocating patent system in 1869, and reintroduced patents in 1912.

International agreements do not have a legislative feedback loop. Democracies are dependent on the other party to be able to change the agreement. The possibility to withdraw from an agreement provides some safeguard. Adding ISDS to trade agreements takes away this safeguard as it is practically impossible to withdraw from trade agreements.

1.9 Treaty shopping

A US company will be able to use the proposed ISDS agreement between the EU and Canada, by setting up a subsidiary in Canada and invest from there in the EU. The same is true for any multinational.

The US does not have an ISDS agreement with Australia. Philip Morris sues Australia under a Hong Kong - Australia ISDS agreement, after setting up a subsidiary in Hong Kong. This treaty shopping opens up a single ISDS agreement to all multinationals.

2 Commission reform proposals

This section discusses the EU commission’s reform proposals, which it presents in its consultation. The commission reforms both substantive investment protection provisions and procedural (ISDS) rules. (Commission, 2014b, all commission references in this section to this document)

2.1 Procedural rules: ISDS

The commission’s proposals do have some positive elements: better transparency – but arbitrators not judges will decide on transparency issues. The commission fails to solve other procedural issues.

2.1.1 Institutional safeguards for independence

This note observed above in Section 1.1 that arbitrators have great power and that this power is not surrounded by conventional institutional safeguards for independence. The arbitrators even have perverse incentives and the appointment of arbitrators is not neutral. The system does not observe the separation of powers, executive officials with a link to the US have influence on the appointment of arbitrators (Section 1.2). The US has an unfair advantage. ISDS has characteristics of a rigged system.

The commission evades these issues. In Question 8: Arbitrator ethics, conduct and qualifications, the commission states that it will introduce specific requirements in the TTIP on the ethical conduct of arbitrators, including a code of conduct.

The commission’s approach leaves the system without conventional institutional safeguards for independence, and leaves perverse incentives and no neutral appointment of arbitrators in place. The commission is willing to accept a system that is rigged to the advantage of the US – rigged against the EU and the rest of the world.

The commission’s proposals leave perverse incentives in place. There will be a tension between the perverse incentives and a code of conduct. Actual bias will be hard or impossible to prove. There will be both incentives and room for the arbitrators to act in a biased way.

Adjudicative processes have to be free of reasonably perceived bias. They

need institutional safeguards for independence and to avoid perverse incentives. This will not be the case under the commission's proposals.

In addition to institutional safeguards for independence and avoidance of perverse incentives adjudicative processes need a code of conduct.

It is uncertain whether there will be a good code of conduct. It is impossible to assess the code of conduct as it doesn't exist yet. The International Institute for Sustainable Development (IISD, 2014, page 24) noted: "Given the uncertainty as to whether this Code will ever be finalized and the uncertainty regarding its content, we cannot, at this point in time, agree with the European Commission that steps have been take to address the issue of arbitrator impartiality and independence. Any assessment of impact of the Code would be mere speculation." Furthermore, the commission does not mention issue conflict.

The commission's reforms fail regarding conventional institutional safeguards for independence, perverse incentives, separation of powers, dismantling a rigged system and there is uncertainty regarding a code of conduct.

2.1.2 Unfairness

This note observed in Section 1.5 that the ISDS system is unfair. The commission does not solve these issues.

ISDS tribunals are much less transparent than national courts. This is the only major issue in which the commission's reform proposals make an improvement, but arbitrators not judges will make the decisions on transparency issues.

2.1.3 Human rights

The procedural threat to human rights (Section 1.6) is not solved in the commissions's proposals.

2.1.4 Questions of law

In ISDS systems questions of law are not decided by a court. The commission does not solve this issue.

2.1.5 No legislative feedback loop

This note observed in Section 1.8 that ISDS systems does not have a legislative feedback loop.

The commission intends to add guidance by the parties to the agreement through binding interpretation (question 11 consultation). The word binding is misleading as there is no possibility to enforce this interpretation. Under NAFTA this possibility has hardly been used and the arbitrators were not really impressed by the interpretation.

National supreme courts are embedded in a constitutional and legal culture, they tend to respect the legislator. ISDS tribunals are mostly populated by foreign arbitrators who work in a rigged system and who tend to be expansive in their interpretations.

Moreover, guidance by the parties to the agreement is not comparable with a legislative feedback loop in a democratic society, as it depends on the cooperation of the other party, and is executed by the executive, not the legislator.

2.1.6 Treaty shopping

We saw in Section 1.9 that treaty shopping opens up a single ISDS agreement to all multinationals.

The EU wants to exclude so called “shell” or “mailbox” companies (question 1 consultation). A US company would first have to establish substantial business activities in Canada before this company can make use of an EU - Canada ISDS agreement to sue the EU. This will not stop multinationals as they are big enough to do this.

The commission’s proposals do not help against treaty shopping.

2.1.7 Frivolous cases

Frivolous cases put pressure on states. Under the commissions’s proposals the arbitrators will be able to decide that claims are manifestly without legal merit or are unfounded as a matter of law (question 9 consultation). The arbitrators who are paid at least 3000 US dollar a day will have perverse incentives to accept frivolous cases and let cases drag on.

2.1.8 Filter

The EU wants to include a filter mechanism whereby the parties to the agreement may intervene in ISDS cases where an investor seeks to challenge measures adopted pursuant to prudential rules for financial stability (question 10 consultation). In such cases the parties may decide jointly that a claim should not proceed any further.

The filter mechanism proposed by the commission has a very limited scope (only financial issues), is dependent on other parties, doesn't help against the chilling effect of threats and even creates a perverse incentive, as a country may position itself as a party that does not stop claims.

This note will discuss carve out and filter mechanism separately in Section 3.3.

2.1.9 Appellate mechanism

The ICSID rules have limited appeal possibilities. We saw above that under the ICSID rules the president of the World Bank appoints all three arbitrators in appeal cases. Presently this president is appointed by the US.

This will be the appeal possible under the trade and investment agreements with Canada and other countries, unless the EU and other countries agree otherwise later on. There is no certainty and the outcome is dependent on both parties.

The EU aims to establish an appellate mechanism in TTIP (question 12 consultation). Details are unknown. The ICSID rules are favourable to the US. It is questionable whether the US will agree with deviating from the ICSID rules that give them such a strong position.

Moreover, in any appellate mechanism, other arbitrators who work in a system that creates perverse incentives will decide on the basis of the same broken rules of the ISDS system.

2.2 Substantive investment protection provisions

In the negotiation mandate the commission was tasked to provide the highest possible investment protection.

The substantive investment protection provisions will be interpreted by arbitrators while conventional institutional safeguards for independence are missing, the arbitrators have perverse incentives, and the system is rigged to the advantage of the US (as we saw above). Textual improvements can only have a limited effect.

2.2.1 Investment

Table 1 commission reference text defines the protected investments. It is an open list, containing for instance “intellectual property rights” and “the expectation of gain or profit” (question 1 consultation).

The International Institute for Sustainable Development scrutinized earlier reform proposals. Regarding an open list the IISD (2014, page 12) noted: “The open-ended list is problematic because it allows for the most expansive interpretation by tribunals of what that definition encompasses, since the list that follows is merely indicative. This definition is therefore the least predictable for host states. This increases the risks of being sued.” The IISD notes that Canada and the EU seem to have taken note of the problems of expansive interpretation to some extent, but deems it is much more likely that the formulation used will have limited impact on the initial expansive language of “any asset.”

The definition of investor includes investors who seek to make an investment, this allows claims from investors (for the expectation of gain or profit) that did not even yet made the investment (pre-establishment), while the commission states such claims will not be allowed.

2.2.2 A known major loophole

The IISD noted a loophole in the text regarding the Most Favoured Nation (MFN) clause. Companies will not only be able to use the substantive investment protection provisions in TTIP, but they can cherry-pick from any other investment agreement the EU or EU member state ratified. This is important as EU member states ratified very open ISDS agreements in the past and the first ISDS agreement the EU may conclude (with Canada) is broken as well (as this consultation shows). The IISD (2014, page 15) concluded: “The benefits to the states of the more careful drafting are thus, quite simply, lost.” This referred to all substantive investment protection provisions.

Regarding this loophole the commission notes: “On the ‘importation of standards’ issue, the EU seeks to clarify that MFN does not allow procedural or substantive provisions to be imported from other agreements.” (question 2 consultation)

The commission may seek to clarify this, it did not succeed regarding the substantive provisions. Table 2, article X.2.4: “4. For greater certainty, the “treatment” referred to in Paragraph 1: a. does not include investor-to-state dispute settlement procedures provided for in other international investment treaties and other trade agreements, including compensation granted through such procedures, and b. shall only apply with respect to treatment accorded by a Party through the adoption, maintenance or application of measures.”

Only investor-to-state dispute settlement procedures including compensation are excluded, not substantive investment protection provisions.

Contrary to commission statements, the known Most Favoured Nation loophole still exists. Companies will not only be able to use the substantive investment protection provisions in TTIP, but they can cherry-pick from any other investment agreement the EU or EU member state signed.

Eastern European countries signed very open ISDS agreements with the US prior to joining the EU. The commission uses these agreements as an excuse for ISDS in TTIP, better ISDS rules in TTIP would replace these very open agreements. But with the MFN clause investors can still use old agreements, until European countries have withdrawn from all of them. And after that, investors can use the broken rules in upcoming EU ISDS agreements.

2.2.3 Investor rights trump human rights

The commissions’ proposals does not protect human rights. States can interfere with human rights only by law, if necessary in a democratic society, and only in so far as necessary. States have to respect, protect and fulfil human rights, and human rights arguably have an extraterritorial working. But the substantive investment protection provisions do not protect human rights. The commission’s reference text does mention privacy and health, but does not refer to them as human rights, but only as an exception to investment and trade rules, limited by investment and trade rules. This limits these human rights and reverses the burden of proof. The text creates supreme investors rights which trump human rights. Other human rights are not even mentioned.

The commission may state that the Preamble will contain a reference to human rights, but preambles are not binding. This note will make further observations on human rights in Section 3.1.

2.2.4 No general right to regulate

The commission's proposal contains a very broad definition of investment. The right to regulate is formulated as exceptions to investment protection. There is no general exception that safeguards the right to regulate. The various protection clauses have their own limited exceptions.

There is no general right to regulate. The Preamble does not create such a right. Commission reference text Table 5, Preamble: "RECOGNISING the right of the Parties to take measures to achieve legitimate public policy objectives on the basis of the level of protection that they deem appropriate," (question 5 consultation)

A preamble is not binding. Furthermore, the right to take measures is limited to "legitimate" objectives. What are legitimate objectives? Preambles end with something like: "HAVE AGREED as follows:". The answer what is legitimate can be found in the agreement itself. The arbitrators can disregard the preamble.

2.2.5 No margin of appreciation

The Commission's proposal gives foreign investors a much stronger protection than the European Convention on Human Rights (ECHR). The ECHR leaves states a margin of appreciation.

Under article 1 of Protocol 1 to the ECHR every natural or legal person is entitled to the peaceful enjoyment of his possessions. This "shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties." The state decides what it deems necessary. However, under ISDS arbitrators who work in a system that creates perverse incentives will make this assessment.

The substantive provisions do not leave a margin of appreciation to the state. Foreign investors do not face a state's margin of appreciation, while local investors do.

States need a margin of appreciation. States which are constantly battered by threats and legal challenges can not function properly, can not take decisive action.

2.2.6 Reservations and exceptions with unknown scope

Various protection clauses have their own limited exceptions. The scope of article X: Reservations and Exceptions (first mention) in Table 5 is unknown as it contains “(…)” (question 5 consultation). In the reference text the scope is limited to National Treatment and Most-Favoured-Nation Treatment. Thus, these reservations and exceptions do not apply to fair and equitable treatment (FET) and expropriation.

These reservations and exceptions are limited to continuation, procurement, subsidies, and audiovisual services (read: the exception culturelle). This leaves open the possibility to challenge continuation, procurement, subsidies and the exception culturelle on fair and equitable treatment and expropriation grounds.

In addition, paragraph 4 contains a limited exception for intellectual property rights: “4. In respect of intellectual property rights, a Party may derogate from Article X.3 (National Treatment), Article X.4 (Most-Favoured-Nation Treatment) where permitted by the TRIPS Agreement, including any amendments to the TRIPS Agreement in force for both Parties, and waivers to the TRIPS Agreement adopted pursuant to Article IX of the WTO Agreement.”

First, this exclusion only regards discrimination, not fair and equitable treatment, and expropriation. Second, there are systemic implications, should ISDS function as a new venue to litigate compliance with international intellectual property rights treaties? (Grosse Ruse - Khan, Henning, 2013)

The reservations and exceptions with unknown scope do not leave a margin of appreciation. Regarding the prudential carve-out, see Section 3.3.

2.2.7 Non discrimination

The commissions’s proposal protects foreign investors against discrimination. This non discrimination provision contains a limited exception. Table 2, “Article Y: General exceptions” incorporates exceptions from GATT and GATS and extends them to environmental measures necessary to protect human, animal or plant life or health (question 2 consultation).

GATT and GATS exceptions are limited. GATS article XIV: “Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any Member of measures:”

This leads to the question whether arbitrators who work in a system that creates perverse incentives will interpret GATT and GATS. GATS Article XIV (c) (ii) provides an exception to protect privacy, but not as a human right, but as an exception to investment and trade rules, limited by investment and trade rules. This limits this human right and reverses the burden of proof. This note will further discuss privacy in Section 3.1.1.

2.2.8 Expropriation

The commissions’s proposal protects foreign investors against expropriation, this protection includes the problematic indirect expropriation, a change of rules which has the effect of making profits lower.

The proposal makes an exception for compulsory licenses (question 4 consultation). Table 4, article X: Expropriation, paragraph 5: “This Article does not apply to the issuance of compulsory licenses granted in relation to intellectual property rights, to the extent that such issuance is consistent with the Agreement on Trade-Related Aspects of Intellectual Property Rights in Annex 1C to the WTO Agreements (‘TRIPS Agreement’).

First, this exclusion only regards expropriation, not fair and equitable treatment and discrimination. Second, this leads to the question whether arbitrators who work in a system that creates perverse incentives will interpret the consistency of compulsory licenses with the TRIPS agreement, will, regarding access to medicine, decide on the matter of preventable suffering and death. Third, note that the EU and US use a more limited interpretation of the Doha Declaration on TRIPS and Public health than the WTO. (KEI, 2011) This has negative consequences for public health. The EU and US can not be expected to properly defend against ISDS claims regarding this. A weak defense will lead to case law with negative consequences for public health, this creates a negative incentive.

Table 4, Annex (3): “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

by 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.”

The exception is limited to measures to protect legitimate public welfare objectives. Arbitrators, not judges, will decide on what is legitimate. The arbitrators will also decide whether measures are manifestly excessive. There is no margin of appreciation. This note discusses the implications for privacy, copyright and patent law below in Section 3.1.1 and Section 3.2.

2.2.9 Fair and equitable treatment

The commissions’s proposal protects foreign investors against treatment that is not fair and equitable. The commission states that the FET standard will be limited to a closed list of basic rights for investors (question 3, Table 3). But the list is not explicitly closed, it does not have a formulation such as “limited to”.

Furthermore, an expert interviewed by Inside US Trade argued “that many of the definitions listed in the EU’s closed list are also not legally well-defined and could invite arbitrators to bring their own value judgments to cases without being tethered to norms accepted by governments. The closed-list structure of the definition is irrelevant if the items within the list are open-ended, he said, adding that this could introduce exactly the kind of uncertainty the EU is trying to avoid.” (IUST, 2014)

Besides the list, the commission wants to protect contracts and expectations investors may have.

Umbrella clauses are controversial. An umbrella clause creates competence for ISDS tribunals to review contractual obligations (like a contract with an investor).

The commission mentions problems with umbrella clauses (question 3 consultation). In the last paragraph it states: “In line with the general objective of clarifying the content of the standard, the EU shall also strive, where necessary, to provide protection to foreign investors in situations in which the host state uses its sovereign powers to avoid contractual obligations towards foreign investors or their investments, without however covering ordinary contractual breaches like the non-payment of an invoice.”

The limitation mentioned (“ordinary contractual breaches”) is limited and can not be found in the reference text added to question 3. We can however

find it in the definition of investment. The reference text Table 1 mentions “claims to performance under a contract” and other contracts as investments, it excludes some claims to money.

The reference text does not contain an obvious umbrella clause such as: “Each Contracting Party shall observe any obligation it may have entered into with regard to investments of nationals of the other Contracting Party”.

However, the reference text (Table 3, article XX.4) contains “legitimate expectations” which do not even have to be in writing.

Contracts create expectations. The legitimate expectations clause could function as a non obvious umbrella clause. Contracts between a state and an investor will then fall under the competence of arbitrators.

Regarding legitimate expectations as part of the fair and equitable treatment standard, the IISD (2014, page 7) noted: “The introduction of a broad basis for reviewing the legitimate expectations of an investor adds increased uncertainty and subjectivity.” Legitimate expectations goes beyond customary international law.

The Commission intends to ensure that the fair and equitable standard (“legitimate expectations”) is not understood to be a “stabilisation clause” (the right that laws will not change). If this is the intention of the Commission, it should be explicitly in the text.

There is an other problem with legitimate expectations: it does not take new facts into account. States may deem it necessary to change policy, a margin of appreciation is needed.

The commission’s proposal regarding fair and equitable treatment does not solve the kind of uncertainty the EU is trying to avoid and it does not provide a margin of appreciation.

3 Four issues

3.1 Human rights, privacy

Arbitrators who work in a system that creates perverse incentives will be able to review all decisions of the EU and its member states, including decisions of the European Court of Human Rights. This ensures compliance with investors’ rights, but threatens human rights. People whose rights may be

affected by the outcome of cases have no standing. The parties in the conflict can present facts and arguments in absence of other affected parties.

The substantive provisions do not protect human rights. Investor rights trump human rights. Europe has an good human rights system, national courts with appeal to a human rights court, in addition the EU has a Charter of fundamental rights. Human rights are deeply integrated in the European legal system.

The commission's proposals would create a "superior" system without human rights. It is incomprehensible that the commission, the guardian of the treaties, proposes this. The commission's ISDS proposals are fundamentally incompatible with Europe's human rights system.

3.1.1 Privacy

The ideas about privacy differ widely between the US and the EU. The EU regards the protection of personal data in the US as insufficient. Presently cross border flows of data to the US are allowed under a safe harbour agreement, which many in the EU regard as dysfunctional. In a resolution the European Parliament calls for suspension of the safe harbour agreement, the parliament regards such a measure as GATS article XIV compliant (EP, 2014).

The US Trade Representative (USTR) takes the opposite view. The 2014 Section 1377 Review On Compliance with Telecommunications Trade Agreements mentions critical voices in the EU (but not the parliament's resolution). It describes the safe harbour agreement as a "practical mechanism for both U.S companies and their business partners in Europe to export data to the United States, while adhering to EU privacy requirements". The USTR states: "The United States and the EU share common interests in protecting their citizens' privacy, but the draconian approach proposed by DTAG and others appears to be a means of providing protectionist advantage to EU-based ICT suppliers." (USTR, 2014)

If the EU would take strong measures to protect our privacy, for instance through suspension of data flows to the US, could companies use ISDS?

Yes, we saw above in Section 2.2.2 that the commission overlooked a known loophole. Companies will not only be able to use the substantive investment protection provisions in TTIP, but they can use the rules from any investment agreement the EU or a member state signed. This creates major

opportunities for companies to use ISDS against EU privacy measures.

Closing the loophole will not be enough. The US already called measures contemplated in the EU draconian and protectionist. US companies will have various possibilities to challenge measures the EU takes to protect privacy.

They may claim the EU discriminates them, GATS Article XIV (c) (ii) mentioned in Section 2.2.7 protects privacy measures, unless they are a disguised restriction on trade in services – the US already claims the measures would be draconian and protectionist.

US companies may claim the treatment is not fair and equitable, may call measures manifestly arbitrary or abusive – grounds in the commission’s FET proposals, see Section 2.2.9.

US companies may claim the EU expropriates them, may claim that the impact of the privacy measure is so severe in light of its purpose that it appears manifestly excessive, see Section 2.2.8.

An umbrella clause could give US companies additional possibilities, see Section 2.2.9.

Furthermore, in the TTIP negotiations the US tabled a proposal that would prohibit to require local data storage. If included in TTIP, US companies could claim that suspension of data flows amounts to mandatory local data storage, a violation of TTIP. (FFII, 2014b) The Trade in Services Agreement (TISA) may contain a similar provision.

Privacy is a human right in the EU. Strong measures are needed to protect this right. As we saw above, the commissions’s proposals do not protect privacy as a human right. Companies will have various ways to challenge privacy measures, arbitrators will take the decisions. There is a serious risk that measures to protect our personal data will be seen by the arbitrators, who work in a rigged system that gives the US an unfair advantage, as not compliant with investment rules. This would spell the end of privacy protection measures.

The eCommerce market is huge, cloud markets are huge. If the EU would decide to suspend the safe harbour agreement, ISDS claims could be enormous. The threat alone of such claims would have a strong chilling effect. Would the EU dare to protect our privacy, or just give in? ISDS is a very serious risk for privacy.

In a meeting at the Dutch Ministry of Foreign Affairs it was said that the US could use WTO arbitration, so what would ISDS change? First, if trade

rules endanger our privacy, these trade rules have to change, or have to be interpreted in a way that is conform human rights obligations. As states have to respect, protect and fulfil human rights, WTO panels, where states meet, have to do this too. Second, after the Snowden revelations the US would probably not be well advised to start a WTO case on privacy. Third, ISDS adds investment protections to trade rules, adds companies as claimants, adds the possibility of ISDS threats and chilling effects, and adds decisive power to arbitrators who work in a rigged system that gives the US an unfair advantage. ISDS changes the game, creates a severe extra threat to our privacy.

3.2 Reform of copyright and patent law

Copyright does not work well in the digital world. The patent system is inefficient. (Stiglitz, 2008) Many in our societies believe that a major overhaul of copyright and patent law is needed. The commission's ISDS proposals do not protect such reforms. Much like in the case of privacy above, companies can challenge reforms using the known loophole, may claim the treatment is not fair and equitable (manifestly arbitrary or abusive), may claim the EU expropriates them (manifestly excessive, the measure does not serve legitimate public welfare objectives) or possibly that the EU discriminates them (see also "Reservations and exceptions with unknown scope").

An example will clarify this. Canada made a minor adjustment to its patent law, to ascertain better access to medicine. In reaction, United States pharmaceutical company Eli Lilly now claims 500 million dollar in ISDS arbitration. Lilly contends the Canadian measures produced "absurd results" and accused Canada of expropriation. (Wall Street Journal, 2014) Lilly lambasts the Canadian patent policy framework as "discriminatory, arbitrary, unpredictable and remarkably subjective".

A minor adjustment already leads to this. Lilly's claims may be without merit, bigger reforms will lead to stronger reactions, strong threats, a high chilling effect, and as the reforms will go deeper, with bigger effects, possibly more chance on success in ISDS arbitration. ISDS adds decisive power to arbitrators working in a rigged system that gives the US an unfair advantage. ISDS would seriously endanger a major overhaul of copyright and patent law.

Arguably substantive investment protection provisions are not politically neutral. They favour vested interests, as they protect projected profits.

The FFII has argued that EU copyright and patent law has to be made

compatible with the UN International Covenant on Economic, Social and Cultural Rights (ICESCR). (FFII, 2013 and FFII, 2014a) We already saw that the commissions's proposals do not make an exception for human rights. Also note the US did not ratify the ICESCR.

For compulsory licenses, see above Section 2.2.8.

3.3 Prudential carve-out and filter

The substantive investment protection provisions contain a limited carve-out, see Table 5, Article X (second mention). The prudential carve-out for ensuring the integrity and stability of a Party's financial system is limited in paragraph 2: "These measures shall not be more burdensome than necessary to achieve their aim." Measures for ensuring the integrity and stability of a financial system may be rather burdensome. They may be taken over a weekend under a lot of stress. Did the crisis solvers find the least burdensome solution? There is often a possibility to argue that other measures would have been less burdensome for the claimant. The path of least resistance may be to let the taxpayer pay, a socialisation of costs. States need a margin of appreciation. ISDS adds complexity, this heightens the risk on not finding a solution to ensure the integrity and stability of a financial system. High claims are possible, threats are even more possible.

Regarding restrictions consultations shall be held promptly in the Trade Committee, adding complexity during a crisis.

Under the proposed EU rules on who pays the damages, the one who took the decision will have to pay. In a crisis situation, member state, commission, council, IMF may come together. Who did then take the decision? Uncertainty over who may face an ISDS claim adds complexity during a crisis. The Eurozone has a euro with design flaws, ISDS would add for-profit arbitration as a complicating factor.

The prudential carve-out is accompanied by a procedural (ISDS) measure. The EU wants to include a filter mechanism whereby the parties to the agreement may intervene in ISDS cases where an investor seeks to challenge measures adopted pursuant to prudential rules for financial stability. In such cases the parties may decide jointly that a claim should not proceed any further.

The word to highlight is jointly. The party in crisis is dependent on the other party. Being dependent on other parties during a crisis will make solving a

crisis more complex. A filter also doesn't help against the chilling effect of threats as the decision on whether the claim can proceed or not comes later. Furthermore, the EU intends to conclude many trade and investment agreements. A country may position itself as a party that does not stop claims. Vulture capitalists will choose that country to invest from. The filter mechanism creates a perverse incentive. There is a higher chance on compromising the stability and integrity of the financial system.

The filter mechanism proposed by the commission has a very limited scope (only financial issues), is dependent on other parties, doesn't help against the chilling effect of threats and even creates a perverse incentive.

3.4 Lack of necessity

The majority of EU member states as well as large emerging economies are currently not covered by US ISDS agreements. ISDS agreements are in place between the US and nine "new" EU member states; they cover one per cent of US FDI stock in the EU and 0.1 per cent of the EU FDI stock in the US. (UNCTAD, 2014) An ISDS agreement with the US would vastly increase EU and US exposure to ISDS cases against public interest policies.

Presently a minority of global foreign investments is covered by ISDS, after ISDS agreements between the major capital exporting countries a large majority of global foreign investments would be covered by ISDS.

There is a lack of necessity. The commission states: "Despite the general solidity of developed court systems such as the US and the EU, it is possible that investors will not be given effective access to justice, e.g. if they are denied access to appeal or due process, leaving them without any effective legal remedy. ISDS is therefore necessary to allow legitimate claims to be pursued. In such cases, the investors would have to prove that the measures have breached the investment protection provisions and that it caused them damage." (Commission, 2014b)

The commission used this argument before. Members of EU parliament Franziska Keller (Greens/EFA) and David Martin (S&D) asked the commission for examples of cases where foreign investors have been denied access to local courts, expropriated, and not paid compensation in the USA. (Keller, F. and Martin, D., 2013) In its answer the commission gave examples. (Gucht, De, K., 2014) Kleinheisterkamp (2014) scrutinized the answer and notes that a closer look suggests that the cases actually undermine the strength of the

commission's argument rather than supporting it. Despite being refuted, the commission uses the argument in its introduction to the consultation.

The Multilateral Investment Guarantee Agency (MIGA), a member of the World Bank Group, offers insurance for political risks. If problems arise, they are very effective in settling them. This approach does not have any of the problems ISDS has. There is also commercial political risk insurance.

ISDS is not needed, companies can use national courts and insurance (Stiglitz, 2013), states can use state-to-state arbitration. The US – Australia trade agreement does not contain ISDS.

4 Conclusion

This note concludes that investor-to-state dispute settlement lacks conventional institutional safeguards for independence and has characteristics of a rigged system. The appointment of arbitrators is not neutral and gives the US an unfair advantage. The US never lost an ISDS case, we can not expect European companies to win major ISDS cases against the US, all the more as the US is not shy to exert pressure on arbitrators. We can expect that US companies will win ISDS cases against the EU and member states. This leads to four considerations.

First, ISDS arbitrators will be able to review all decisions of governments, legislators and courts, including the European Court of Human Rights, and they can award unlimited damages. The European Commission aims to add ISDS to trade agreements from which it is near impossible to withdraw. Given that ISDS lacks conventional institutional safeguards for independence, does not observe the separation of powers, has characteristics of a rigged system and gives the US an unfair advantage, the transfer vast powers to arbitrators without possibility of withdrawal would be imprudent. At the very least, to protect its future, the EU has to avoid a lock-in, should not deviate from standing European practice of stand-alone investment agreements. The EU should not add ISDS to trade agreements.

Second, the EU aims to create a global standard. Presently a minority of foreign investments is covered by ISDS, after ISDS agreements between the major capital exporting countries a large majority of global foreign investments would be covered by ISDS. Wide coverage of global foreign investments and impossibility to withdraw would create a near global lock-in. Given that the commission's reforms fail on many counts, a near global lock-in would

give arbitrators unprecedented and unchecked powers. This would burden democracies, local companies, tax payers, human rights and the rule of law.

Third, quintessentially, states need a margin of appreciation. States which are constantly battered by threats and legal challenges can not function properly, can not take decisive action. The US protect themselves through a system rigged to their advantage. It is an existential threat to the EU not to be able to take decisive action, especially since the US can. Raison d'état necessitates to avoid this situation.

Fourth, foundationally, an essential aspect of liberalism is constitutional liberalism – the separation of powers, the creation of strong institutions. Sovereign decisional power accompanied by strong institutions can provide fairness. ISDS undermines the institutions. ISDS undermines the EU's vital interests and values, it has to be rejected. In doing so, the EU would give direction to the debate and create room to strengthen alternatives.

Acknowledgement

The FFII is greatly indebted to numerous publicists, people who shared draft submissions and to many with whom the author discussed the system, like members of the Seattle to Brussels Network and others who remain anonymous.

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