

# GEGI Exchange

A Global Economic Governance Initiative policy brief

## Investment Provisions in Trade and Investment Treaties: The Need for Reform

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The Global Economic Governance Initiative is a project of Boston University's Pardee School of Global Studies, the Pardee Center for the Study of the Longer-Range Future and the Center for Finance, Law and Policy. GEGI was founded in 2008 to advance policy-relevant knowledge about economic governance for financial stability, human development, and the environment.

Nations of the world are currently negotiating a variety of significant trade and investment treaties that cover upwards of eighty percent of the world economy. The Trans-Pacific Partnership (TPP) would further integrate a number of Pacific-Rim nations; the Trans-Atlantic Trade and Investment Partnership (TTIP) would be a treaty between the United States and European countries. The United States and others are also negotiating major bilateral investment treaties (BITs) with China and India.

As the negotiations have progressed, the investment provisions of these treaties have become increasingly controversial—though they are not well understood. This short policy brief highlights three core concerns about the investment provisions in contemporary treaties that have received significant scrutiny in scholarly and policy circles. These provisions go well beyond conventional notions of “free trade” and tend to:

- grant foreign investors greater rights than host country governments and citizens;
- use procedures that give special access to foreign corporations; and
- lack an independent impact on levels of investment in the economies of treaty signatories.

Given these aspects of investment treaties, host countries may be surrendering a considerable amount of policy sovereignty that is needed to boost economic growth and protect the public welfare—without being compensated for such losses through increases in foreign investment and economic growth.

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Fortunately, policy-makers and the broader public have come to recognize that non-trade issues such as investment now form the core of most trade and investment treaties. The aim of this policy brief is to highlight the hazards created by this change and present options for reform so as to contribute to a discussion of how trade and investment treaties can ensure both economic prosperity and responsible governance.

## Granting Greater Rights to Foreign Investors



The U.S. Congress and European Parliament have taken the position that trade and investment treaties should protect foreign investors from discrimination without providing them with greater rights than citizens. The substantive standards of protection in these agreements, however, go far beyond prohibiting discrimination against foreign investors. In addition to nondiscrimination rules (known as “national treatment” and “most favored nation”), these treaties contain language granting foreign investors greater rights than those typically enjoyed by citizens under domestic law. The most significant sources of these rights are contained in provisions on “indirect expropriation” and “fair and equitable treatment” (FET). Moreover, there are few and limited safeguards that allow countries to deviate from these provisions in order to protect the public welfare.

### Indirect expropriation

The domestic law of most countries requires the government to compensate property owners when property is seized or “expropriated” for public use. The law of some countries—including the United States—also under certain limited circumstances requires governments to compensate property owners when they regulate property in a manner that has an economic effect comparable to expropriation. Most countries, however, do not require compensation based on the adverse impacts of regulations. Virtually all regulations have a negative economic impact on someone and, if compensation was required for all such impacts, many regulations would simply be too costly to implement.

Yet the expropriation provisions of trade and investment treaties explicitly apply to both “direct” and “indirect” (i.e. regulatory) expropriation. The right to compensation for regulatory measures under these treaties has been interpreted more expansively than the comparable right in countries that recognize regulatory expropriations.<sup>1</sup> Under U.S. law, for example, a regulation typically must cause the complete or near-complete destruction of the value of property in order to constitute a regulatory expropriation. In contrast, investment tribunals have required compensation when a measure results

in only a “significant” or “substantial” adverse economic effect.

In the widely-cited *Metalclad v. Mexico* award,<sup>2</sup> for example, the tribunal held that under NAFTA’s expropriation provision an investment in a hazardous waste facility was indirectly expropriated by the decisions by municipal and state governments to deny a construction permit for the facility and designate the affected area as an ecological preserve. The tribunal indicated that the international standard for indirect expropriation covered not only seizures of property but also “incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host State.”<sup>3</sup>

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In addition, the treaty standard for indirect expropriation covers a scope of “investment” that is much broader than the rights related to real estate that are protected under regulatory expropriation doctrines in some countries’ domestic law. The 2012 U.S. Model BIT is illustrative, defining investment to include “every asset that an investor owns or controls, directly or indirectly, that has the characteristics of an investment, including . . . the commitment of capital or other resources, the expectation of gain or profit, or the assumption of risk.”<sup>4</sup>

The broad scope of covered investment has encouraged investors to bring indirect expropriation claims based on a wide range of regulatory measures. Pending disputes include challenges by Philip Morris to cigarette labeling laws in Uruguay and Australia arguing that the labeling restrictions

have indirectly expropriated their intellectual property rights<sup>5</sup> and a claim by a U.S. company arguing that Quebec expropriated its oil and gas exploration permit through its moratorium on hydraulic fracking for natural gas.<sup>6</sup> Even if these claims are all dismissed, governments always face the risk of losing new challenges based on similar arguments, at a potentially severe and unavoidable financial cost, due to the ad hoc nature of the arbitration process.

#### Fair and equitable treatment

The fair and equitable treatment (FET) provisions of trade and investment treaties are the most common grounds for successful claims by foreign investors and provide even more extensive rights than the language on indirect expropriation. Investment tribunals have indicated that FET encompasses an “evolving” and therefore expanding set of rights. Tribunals have interpreted FET to include a right to a “stable and predictable legal environment,” which enables foreign investors to challenge changes in regulatory standards that adversely affect their “legitimate expectations” about the value or profitability of their investments. As the U.S. State Department has acknowledged, there is no comparable right to compensation under U.S. law.<sup>7</sup>

Tribunals have also interpreted FET to include a variety of tests that allow tribunals to second-guess government policy decisions. In the recent *Bilcon* case against Canada, for example, the tribunal indicated that FET can be violated by conduct a tribunal considers to be “unjust,” “unfair,” or reflecting a “manifest failure of natural justice....”<sup>8</sup> Applying this standard, the *Bilcon* tribunal concluded that Canada violated FET by rejecting a proposed basalt quarry and marine terminal in Nova Scotia following an assessment of its social and environmental impacts. Domestic law standards of review for economic regulations are typically much more deferential to the authority of governments to regulate economic activity and do not permit courts to substitute their judgment for that of governments concerning the fairness of regulatory measures. In *Bilcon*, the foreign investor was able to avoid such standards of review by bringing a claim directly before an investment tribunal without seeking judicial review in Canadian courts.

#### Weak exceptions and safeguards

The substantive standards of protection in investment treaties come with limited safeguards that do not adequately protect governments’ ability to regulate to protect the public interest. For example, U.S. investment treaties permit countries to insulate certain types of measures from challenge under some foreign investor rights, but this mechanism does not apply to expropriation or FET,<sup>9</sup> which have been the bases for most successful investor claims.

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A key concern is that recent treaties lack a safeguard for preventing and mitigating financial instability. Some treaties include an exception for prudential measures, but it is available only in narrow circumstances and often includes circular or self-canceling language that greatly reduces its effectiveness. Moreover, no U.S. treaty since the 1994 North American Free Trade Agreement has included even a qualified balance-of-payments exception that allows countries to take emergency measures to stem a financial crisis.<sup>10</sup>



In the World Trade Organization, countries resolve disputes with each other before state-to-state dispute settlement panels.

In contemporary trade and investment treaties, a large part of the dispute settlement process is governed by foreign investors in a process called “Investor-State Dispute Settlement (ISDS).” Scholars and policy-makers have raised at least five major concerns with ISDS as proposed in the Trans-Pacific Partnership and the Transatlantic Trade and Investment Partnership and, potentially, in future U.S. and European investment treaties with China.

1. ISDS shifts key powers to for-profit arbitrators who are not publicly-accountable or judicially independent.<sup>11</sup> Whenever foreign investors choose to bring a claim, the arbitrators are given the power to make final decisions about what a country can do in its sovereign legislative, executive, and judicial capacity. They can also assign vast amounts of public funds to foreign investors. They are subject to very limited or no judicial review, depending on the rules under which the foreign investor chooses to bring its claim.
2. ISDS does not satisfy basic standards of judicial independence and fair process.<sup>12</sup> For example, it does not allow state or local governments, or domestic investors, a right of standing in the process alongside the foreign investors, even if they have a direct interest, such as a reputational interest, in the dispute. Further, ISDS uses a for-profit process of arbitration in which conventional safeguards of judicial independence are absent, with little or no judicial supervision. Due to the existence of confidential ISDS cases, conflicts of interest in the arbitration process – arising from the common practice of arbitrators working on the side as ISDS lawyers – cannot be policed effectively by the parties or anyone else, even under those treaties that allow for more openness in ISDS.
3. ISDS gives foreign investors a range of benefits that are not available to domestic investors and citizens.<sup>13</sup> As a result, it reconfigures a country’s institutions in favor of foreign investors and against anyone with conflicting interests. For example, only foreign investors can bring an

ISDS claim to protect their assets, broadly defined. Because of the high cost of ISDS, the primary financial beneficiaries have been large companies and very wealthy individuals. ISDS lets them bring international claims against countries without having to go first to the courts that protect everyone else.

4. ISDS poses significant risks to democratic accountability and regulatory flexibility.<sup>14</sup> ISDS disciplines are unique as a basis for litigation risk of governments because they lead to an uncapped order of compensation against the nation. Even if a claim is brought and lost by a foreign investor, or threatened but not initiated, the ability to bring an ISDS claim is a unique lobbying tool.

To illustrate, in November of 2014, the Canadian Council of Chief Executives warned Canada’s federal government that Canada would face ISDS claims if the government proceeded with new anti-corruption rules.<sup>15</sup> It will be very difficult if not impossible to assess the impacts of these threats because they relate to decision-making and possible negotiations off the public record. Yet, the warnings illustrate the bargaining option that ISDS gives to major companies. Table 1 provides a few other illustrative cases, among hundreds of known ISDS arbitrations, where private firms have filed claims against host country regulations for financial stability, public welfare, and environmental protection.

5. If ISDS is included in a small number of proposed trade and investment treaties, the role of ISDS would expand massively. For example, as measured by the amount of FDI flows to which it would apply, the TTIP is far more significant than all of the thousands of existing investment treaties combined. The TTIP will cover about 50-60% of all investment flows in and out of the U.S.; about 15-20% of those flows are covered by existing treaties.<sup>16</sup> A few other treaties—especially the TPP, an EU-China investment treaty, and a U.S.-China investment treaty—would expand ISDS coverage to over 80% of the investment flows.

Table 1: ISDS and Public Welfare: Illustrative Cases

Issue	Illustrative Case
Health Care	Eli Lilly v. Canada (drug patents)
	Philip Morris v. Uruguay (tobacco law)
Financial Reform	Abalclat vs Argentine Republic (debt swap)
	Saluka v. Czech Republic (too big to fail)
Environmental Protection	Chevron v. Ecuador (Amazon pollution)
	Renco v. Peru (toxics and mining)
Wages and Equality	Veolia v. Egypt (minimum wage)
	Piero Foresti v. South Africa (black empowerment)

### Economic Benefits are Limited

There is limited evidence that trade and investment rules have an independent impact on attracting new investment flows to host governments. What is more, econometric evidence is even more limited regarding the extent to which foreign investment spurs economic growth when it does flow to host country economies.

A number of studies have examined the extent to which trade and investment treaties have an independent impact on attracting foreign investment to host nations. The majority of these studies have found weak or nonexistent correlations between treaties and attracting investment flows.<sup>17</sup>

The foreign investment that does result from opening up an economy does not necessarily have the desired impacts of economic growth and well-being. Olivier Jeanne, Arvind Subramanian, and John Williamson at the Peterson Institute for International Economics conducted a sweeping “meta-regression” of the entire literature that includes 2,340 regression results and found little correlation between opening up to foreign investment and economic growth. The authors concluded: “the international community should not seek to promote totally free trade in assets—even over the long run—because (as we show in this book) free capital mobility seems to have little benefit in terms of long run growth.<sup>18</sup>” Other economists have demonstrated that opening to foreign investment is associated with a higher probability of financial instability.<sup>19</sup>

Trade and investment negotiations are often a series of trade-offs where a country may relinquish

measures that in their absence will impair an economy in exchange for market access as long as the net economic benefits are positive. It is not clear that trading away the right to regulate for public welfare, and being required to defend such regulations in an imbalanced dispute settlement system, will yield net economic benefits.

### Options for Reform

The world economy needs more trade and investment to raise the standards of the world’s people in a manner that is socially inclusive and environmentally sustainable. Trade and investment treaties can be useful tools to achieve those goals. Unfortunately, at this writing, current and proposed treaties harbor investment rules that skew the incentive structures of economies away from these end goals.

The text box below lists a series of options for reform, categorizing them as reforms that would address the concerns with ISDS either (a) in a broad-based way at an institutional level or (b) in a piecemeal way that leaves important and broader concerns outstanding.

This list of reform is not an exhaustive one, but coupled with the discussion above it is our hope that this short brief will support a more focused dialogue on these issues. As noted earlier, over eighty percent of the world economy would be governed by these new treaties. It is essential that they put in place the right incentives to steer the global marketplace toward economic growth that is inclusive and sustainable.

### Broad-based reforms:

1. Exclude ISDS from the treaty. Countries such as Australia, South Africa, and Ecuador have pursued this route.
2. Replace ISDS with a judicial process.
3. Impose investor responsibilities in addition to granting investor rights,

### Piecemeal reforms:

#### i. Procedures

- (1) Require prior exhaustion of local remedies
- (2) Prohibit arbitrators from acting as advocates in other ISDS cases.
- (3) Deny benefits of ISDS to domestic companies, including foreign subsidiaries that they own or control.
- (4) Exclude lost profits from awards of monetary compensation.
- (5) Provide standing to any affected party (e.g., community next to a mine).
- (6) Provide full transparency of ISDS proceedings, documents and terms of settlement.
- (7) Enforce contractual forum selection clauses

#### ii. Substantive rules

- (1) FET – Require investors to prove a violation of customary international law, based on evidence of state practice and opinio juris.  
-- Alternative: Limit FET to denial of procedural due process in domestic courts and tribunals.
- (2) Expropriation – Limit to direct taking of ownership or control of an asset.
- (3) National treatment – Limit to facially discriminatory measures.
- (4) Most-favored nation treatment – Do not include MFN at all.
- (5) Scope of covered investments – Limit protection to investments that are made in accordance with domestic law.
- (6) Foreign investor responsibilities – Develop actionable rules of due diligence and obligations to comply with domestic law, international human rights, and multilateral environmental agreements.

#### iii. Safeguards for protecting the public

- (1) Include a clear and unqualified affirmation of the right to regulate of the state.
- (2) Financial services –
  - (a) Make the prudential language self-judging.
  - (b) Include broader financial services exception for measures to protect consumers and communities.
  - (c) Ensure that balance of payments safeguards are in place that grant nations the right to regulate the inflow and outflow of capital to prevent and mitigate financial instability
- (3) Public health generally – Carve out health systems and regulatory standards.
- (4) Deference – Establish principles of deference to domestic legislatures and agencies (as exist in domestic law)



1. See Matthew C. Porterfield, *International Expropriation Rules and Federalism*, 23 *STANFORD ENV'T L LAW JOURNAL* 3, 8-11 (2004) (discussing the degree of adverse economic impact necessary to constitute a “regulatory taking” under U.S. law).
2. *Metalclad Corp. v. United Mexican States*, ICSID Case No. ARB(AF)/97/1 (Arbitral Trib. 2000), available at <http://www.italaw.com/sites/default/files/case-documents/ita0510.pdf>.
3. *Id.*, para. 103.
4. 2012 U.S. Model Bilateral Investment Treaty, Article 1 (“Definitions”), available at <http://www.ustr.gov/sites/default/files/BIT%20text%20for%20ACIEP%20Meeting.pdf>.
5. See *Philip Morris Products S.A. v. Uruguay* (ICSID), Request for Arbitration, paras. 82-83 (Feb. 19, 2010), available at <http://www.italaw.com/sites/default/files/case-documents/ita0343.pdf>; *Philip Morris Asia Ltd. v. Australia* (UNCITRAL), Notice of Arbitration, para. 10(a) (Nov. 21, 2011), available at <http://www.italaw.com/sites/default/files/case-documents/ita0665.pdf>.
6. See *Lone Pine Resources Inc. v. Canada* (UNCITRAL), Notice of Arbitration, paras. 48-52 (Sept. 6, 2013), available at <http://www.italaw.com/sites/default/files/case-documents/italaw1596.pdf>.
7. See *Glamis Gold v. United States of America*, Counter-Memorial of Respondent United States of America, at 234 (Sept. 19, 2006) (“United States law does not compensate plaintiffs solely upon a showing that regulations interfered with their expectations . . . It is inconceivable that the . . . standard of treatment required by international law would proscribe action commonly undertaken by States pursuant to national law.”), available at <http://www.state.gov/documents/organization/73686.pdf>.
8. *Bilcon of Delaware et al. v. Canada* (UNCITRAL), Award on Jurisdiction and Liability, para. 442 (March 17, 2015), available at <http://www.appletonlaw.com/News/Bilcon%20Merits%20Award%20-%20March%202015.pdf>. The Bilcon tribunal was quoting from the frequently invoked discussion of FET in *Waste Management Inc. v. Mexico*, ICSID Case No. ARB(AF)00/3, Award, para. 98 (April 30 2004), available at <http://www.italaw.com/sites/default/files/case-documents/ita0900.pdf>.
9. See 2012 Model BIT, *supra* note 4, Article 14 (Non-Conforming Measures).
10. See Viterbo, Annamaria (2012). *International Economic Law and Monetary Measures, Limitations to States' Sovereignty and Dispute Settlement*, London: Edward Elgar; Gallagher, Kevin P (2015), *Ruling Capital: Emerging Markets and the Reregulation of Cross-Border Finance*, New York, Cornell University Press.
11. G. Van Harten, *Investment Treaty Arbitration and Public Law* (Oxford: OUP, 2007); D. Schneiderman, *Constitutionalizing Economic Globalization* (Cambridge: CUP, 2008).
12. G. Van Harten, “Investment Treaty Arbitration, Procedural Fairness, and the Rule of Law” in S.W. Schill (ed) *International Investment Law and Comparative Public Law* (Oxford: OUP, 2010).
13. G. Van Harten, *Sovereign Choices and Sovereign Constraints: Judicial Restraint in Investment Treaty Arbitration* (Oxford: OUP, 2013).
14. S. Montt, *State Liability in Investment Treaty Arbitration* (Oxford: Hart Publishing, 2009).
15. B McKenna, “Ottawa could face lawsuits for strict corruption rules” *Globe and Mail* (24 November 2014).
16. These approximate figures were calculated by G. Van Harten based on existing investment treaty coverage of country-by-country inward and outward FDI flows for the U.S. in 2012 from data in Organization for Economic Cooperation and Development (OECD), “StatExtracts: FDI flows by partner country”, available online: [http://stats.oecd.org/Index.aspx?DataSetCode=FDI\\_FLOW\\_PARTNER](http://stats.oecd.org/Index.aspx?DataSetCode=FDI_FLOW_PARTNER).
17. See Sauvant, Karl and Lisa Sachs (2009) *The Effect of Treaties on Foreign Direct Investment*, London, Oxford University Press and UNCTAD (2014), *Trade and Development Report, 2014*, Geneva, UNCTAD for summaries of this literature.
18. Jeanne, O., Subramanian, A. and Williamson, J. (2013). *Who Needs an Open Capital Account?* Washington, D.C.: Peterson Institute for International Economics, page 5.
19. See Aizenman, J. and Pinto, B. (2011). *Managing financial integration and capital mobility -- policy lessons from the past two decades*. Policy Research Working Paper Series 5786. Washington, D.C.: The World Bank; Reinhart, C. and Rogoff, K. (2010). *This Time Is Different: Eight Centuries of Financial Folly*: New York, Princeton University Press.

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