Stepping Away from ISDS

Four alternatives to Investor-State Dispute Settlement

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Across the world, governments are responding to political pressure to reform or remove the mechanism in trade and investment agreements that grants special privileges to international investors to sue governments – known as ISDS.

This raises an important question for policy makers: what should replace ISDS?

While this is in one sense a leading question – why should international investors enjoy special privileges not afforded to domestic investors and the public at large? – many governments remain keen to promote inward and outward investment, without granting excessive powers to private investors or undermining their own right to regulate.

This briefing summarises four alternative approaches to investment protection recently developed in South America, Asia, Africa and Europe. It provides a recap of the problems associated with ISDS, and assesses how well the alternative approaches resolve them.

As the UK reviews its international investment policies post-Brexit, this briefing should help policy makers in the UK understand how other countries are stepping away from ISDS.

Calling Time on ISDS

The tide is turning against Investor-State Dispute Settlement (ISDS) – a Cold War era international law mechanism that allows international investors to sue governments in private tribunals over legislation and government action that affects their profits. From India to the USA, South Africa to the Belgian region of Wallonia, opposition to new generation trade agreements has centred on criticisms of ISDS.

Although historically ISDS has largely been used by companies in the global north to sue countries in the global south, the mooted inclusion of ISDS in the EU-US trade agreement (known as TTIP), and the use of ISDS powers in NAFTA by north American companies to sue the governments of Canada, the US and Mexico, has exposed the risk ISDS presents to standards, decision making and public services across Europe and North America. It has even been suggested that the UK government could face multiple ISDS challenges post-Brexit, putting the taxpayer on the line for billions of pounds.

To date, companies have used ISDS claims or the threat of an ISDS claim to undermine government action from fracking moratoria to patent rules on medicines, oil pipelines, cigarette packet labelling, pollution from power stations, and decision after decision on dangerous mines.

Political opposition to ISDS is not going away. Each new case to emerge only sharpens public understanding of the risks. Indeed, it has been said that to oppose ISDS, it is only necessary to understand it. As such, it has become incumbent on policy makers to develop effective alternatives.

So how do efforts around the world to step away from ISDS measure up?

Alternatives in a Nutshell

The Brazilian model, which forms the basis of an intra-MERCOSUR agreement, provides a genuine alternative to ISDS. The India model BIT and Morocco-Nigeria BIT retain the ISDS mechanism, but introduce novel mechanisms to increase investor responsibilities, curtail far reaching investor rights, and establish the state's right to regulate. One highlight of the Morocco-Nigeria BIT is the requirement that companies are made liable under domestic law for their activities overseas – a big innovation for investment treaties.

The EU's Investment Court System (and its proposal for a Multilateral Investment Court) is less ambitious, and does not address the substantive problems of the ISDS system. It is more of a reformulation of ISDS than an alternative.

So What's Wrong with ISDS?

To understand what is wrong with ISDS, it is helpful to group problems into those of *substance* (the privileges granted to investors) and those of *process* (how those privileges are accessed and adjudicated).

The substance

1. **Excessive and loosely defined privileges for international investors**: Investment agreements grant private investors privileges that exceed those enjoyed under domestic law. Agreements usually lack a narrow definition of these privileges, giving arbitrators a free hand to interpret them expansively. For example, **Fair and Equitable Treatment** clauses require governments to treat investors 'fairly' and not upset their 'expectations' even when these expectations are unreasonable, for example, an expectation that taxation or regulatory regimes would never change. They have permitted investors to bring disputes against a wide range of government activities from changes in tariff charges in

public utilities to withdrawal of tax exemptions and changes to the regulation of chemicals. **Indirect Expropriation** clauses provide for compensation where a regulatory measure is considered to harm, affect or interfere with an investment. This can cover a wide range of government actions and measures, ranging from taxation to environmental regulation.

2. **A catch-all definition of 'investment'**: Investment agreements typically cover every type of asset – including an interest in sovereign debt, or portfolio investments (e.g., owning shares in a company – see glossary). This swells the number of potential claimants able to launch an ISDS case.
3. **Quasi international jurisdiction for investors:** The 1958 New York Convention enables investors to enforce an ISDS award against a government in domestic courts almost anywhere in the world.
4. **Huge liabilities for taxpayers or 'regulatory chill'**: There is no limit to the size of damages that tribunals can award against governments, which can run to hundreds of millions and even billions of pounds. So governments can defend a new law or decision and risk huge liabilities for the taxpayer, or drop a measure (or avoid introducing a measure) to avoid an ISDS challenge. This is referred to as 'regulatory chill', and is a greater issue for poorer countries that lack the resources to risk losing an ISDS challenge.
5. **No obligations for investors**: Investment agreements rarely create corresponding obligations for investors to abide by the laws of the country in which they do business, let alone to respect human rights, labour, environmental and other public international norms.

The Process

1. **Ad-hoc tribunals with institutional bias**: ISDS claims are brought in private tribunals outside of the domestic court system. There is often no requirement to first exhaust or even pursue remedies in domestic courts. Tribunals are not permanent, but set up on an ad-hoc basis. Arbitrators are selected from a small pool comprising largely corporate lawyers, many of whom engage in 'double-hatting' (acting as an arbitrator in one case and representing a corporate claimant in another). Given that only investors can raise claims, not states or other affected parties, it's unsurprising that a growing body of empirical research indicates that ISDS tribunals exhibit bias in favour of investors.
2. **High legal costs:** Average legal costs for an ISDS case average US $8 million. Even if a country successfully defends a measure, it may have to pay all, or a part of these costs, adding to the effect of 'regulatory chill'.
3. **Big business favoured over SMEs and civil society**: ISDS is, by definition, only available to investors, and small and medium sized companies lack the resources to bring an ISDS claim. This means that ISDS gives big business an advantage over SMEs to influence government policy, while civil society remains shut out.
4. **Lack of transparency in proceedings**: There is no obligation on tribunals to publish their decisions, or even to notify the public of the existence of an ISDS case. If a government settles a claim there may be no publicly available record, meaning no scrutiny.
5. **Treaty shopping by investors:** Investors can set up shell companies in other countries, or rearrange corporate structures, in order to sue under investment treaties that contain the most favourable terms.
6. **Financial institutions speculating on outcome of cases**: Known as 'third-party funding', financiers cover the legal fees of a case to enable investors to sue governments, in exchange for a large cut of any eventual award. This swells the number of ISDS cases, as suing the government becomes a business model in its own right.

For an in-depth account of ISDS, see TJM's report on the UK's Bilateral Investment Treaties.

Alternative #1: The Intra-MERCOSUR Investment Facilitation and Cooperation Protocol

What is the Intra-MECOSUR agreement? An agreement between Brazil, Argentina, Uruguay and Paraguay, signed in April 2017, designed to facilitate capital flows between the four countries.

Political context: Brazil has never ratified a Bilateral Investment Treaty on the grounds that ISDS limits the government's right to regulate, and puts domestic investors at a disadvantage. In recent years Brazil has developed a model that goes beyond traditional investor protections and aims at facilitating reciprocal, productive investment flows between countries. The model, known as the Cooperation and Facilitation Investment Agreement (CFIA) has formed the basis of agreements between Brazil and Chile, Colombia, Mexico, Peru and Jordan. The Inta-MERCOSUR agreement is based on the CFIA model.

Pros: Under the Intra-MERCOSUR agreement, investors seek redress by taking complaints to a national Ombudsmen. As a last resort, a state-to-state dispute settlement process is available. Importantly, the agreement does not contain an ISDS mechanism through which investors can sue states directly.

The agreement clarifies the range of investor protections, excluding 'fair and equitable treatment' (replaced by more specific standards like access to justice), excluding protections from 'indirect expropriation' and excluding 'full protection and security'. Further, the agreement narrows the definition of investment, which includes foreign direct investment (FDI) but excludes short term, speculative portfolio investments. The enterprise-based definition more explicitly ties protection to economic activities, rather than broadly defined 'assets'. Sovereign debt is also excluded.

The agreement protects governments' right to adopt, maintain and enforce environment, labour or public health legislation (with the limitation that measures cannot be applied in a way that constitutes a disguised trade restriction). Though this is not a carve-out for public interest legislation, the framing makes it harder to challenge regulation. The agreement also creates an obligation for investors to comply with national law and not engage in corruption, and includes an article (though non-binding) on corporate social responsibility.

Cons: A full carve-out for public interest areas of legislation – rather than a limited right to regulate – would provide states with greater protection. The agreement could go further in creating investor obligations that precondition access to investor protections created by the agreement, on respect for human rights, sustainability and good corporate governance.

Verdict: The Intra-MECROSUR agreement is a genuine alternative to ISDS – providing legal certainty to investors without granting expansive and unnecessary powers that threaten the governments' right to regulate. The agreement significantly departs from standard investment treaty practice, particularly on standards that have enabled investors to challenge regulatory measures. The agreement is not perfect and could go further in some areas of public interest protection, but it provides a valuable example for other countries to learn from.

Alternative #2: India's Model Bilateral Investment Treaty (BIT), 2016

What is India's model BIT? A model investment treaty developed by India in 2016, containing the provisions India would like to see in its future investment treaties. The 2016 model BIT replaces India's 2003 model BIT, which was criticised for promoting rules that give international investors too much power at the expense of Indian regulators.

Political context: Since 2010, India has experienced a surge of ISDS claims against it. There are currently 11 ISDS cases reported pending against India – one of the highest of any country. Unsurprisingly, Indian policy makers have responded to restrictions on their freedom to regulate by serving notices to 82 countries, seeking the termination or clarification of the BITs through which ISDS cases are launched. Still keen to promote both inward and outward investment, India has developed its own model BIT in an effort to strike a better balance between investor protections with investor responsibilities and the government's freedom to regulate. The 2016 model BIT was introduced after the arguably more ambitious 2015 draft BIT received significant push back from the business community.

Pros: The model BIT takes an enterprise-based definition of investment, requires the investment to be operated 'in good faith' and defines an investment as that which has "significance for the development of the Party in whose territory the investment is made'. Portfolio investments and government debt are excluded from the definition. Further, investors must have substantial business activities in their home state, and either state can withdraw protections where an investment or investor is established for the primary purpose of launching an ISDS case – measures designed to prevent treaty shopping. A 'denial of benefits' clause enables a home state to withdraw investment protections from its investors (giving the home state powers to intervene to halt controversial ISDS cases).

The model BIT does not include the broad right to 'fair and equitable treatment'. Although the model BIT does include protection against 'indirect expropriation', it provides criteria for what constitutes indirect expropriation, removing the potential for expansive interpretations by arbitrators.

The model BIT establishes the state's right to introduce regulation to protect public health and the environment, insofar as these measures are non-discriminatory. The state's right to regulate is further protected by a clause that requires the BIT to be interpreted with a "high level of deference" to the government's implementation of domestic policies.

The model BIT creates an obligation for investors to comply with national law and not engage in corruption, and includes a binding, but non-specific article on corporate social responsibility.

Cons: The model BIT retains the ISDS mechanism. Although it restricts the ISDS process by requiring investors to first exhaust domestic judicial and administrative avenues for at least five years, and introduces a strong transparency requirement for arbitral proceedings, the India model BIT nonetheless grants investors the power to sue governments through private tribunals.

The verdict: There is a lot to admire in India's model BIT, though as with the Intra-MECROSUR agreement, it could go much further in establishing investor obligations. However, its major shortcoming is that it curtails rather than eliminates the ISDS mechanism.

Alternative #3: Morocco-Nigeria Bilateral Investment Treaty

What is the M-N BIT? An investment agreement signed by Morocco and Nigeria in 2016, with the stated aim of "strengthening the bonds of friendship and cooperation" between the two countries. The treaty has yet to enter into force.

Political context: The M-N BIT is one of a number of treaties agreed between Morocco and Nigeria in recent years, including a treaty on the Morocco-Nigeria gas pipeline. These agreements have been described by Morocco's sovereign wealth fund as a "model for South-South cooperation to act as a catalyst for African economic opportunities" and are designed to boost joint investment in food security, renewable energy, natural resource management, and agribusiness and fertilizer production.

Pros: The M-N BIT creates civil liability for investors in their home state for damage, personal injury or loss of life in the host state. It is a significant innovation for an investment treaty to require that companies are made liable under domestic law for their activities overseas. In addition, the M-N BIT requires investors to abide by international environmental, labour and human rights standards to which either state has committed, and requires investors and investments to uphold human rights in the host state.

The M-N BIT uses a similar definition of investment as the India model BIT – enterprise based, in good faith, excluding portfolio investments and government debt – but goes further, narrowing the definition to that which contributes to 'sustainable development'.

The M-N BIT goes further than the India/MERCOSUR approach in establishing an explicit right of the state to regulate, which is not qualified or limited.

Although the M-N BIT creates the right to 'fair and equitable treatment' and 'full protection and security', it limits the scope of these rights to those accorded by customary international law, and clarifies that the BIT does not create additional rights beyond that.

Cons: As with the India model BIT, the M-N BIT retains the ISDS mechanism. This is particularly concerning given that the M-N BIT also protects investors from 'indirect expropriation' without providing positive criteria for what constitutes indirect expropriation. The possibility of an ISDS challenge based on an expansive interpretation of this right has the potential to undermine the right to regulate provisions elsewhere in the BIT.

The verdict: The M-N BIT contains novel and ambitious measures on investor responsibility, sustainable development and the right of the state to regulate. However, the presence of ISDS and some expansive investor rights could undermine efforts to create a space in which the state can regulate and hold business to account effectively.

Alternative #4: The EU's Investment Court System

What is ICS? A model dispute resolution process developed by the EU and contained in the EU's latest bilateral trade deals with Canada (known as CETA) and Vietnam. ICS leaves investment protections largely unchanged, but introduces procedural reforms including the creation of a permanent tribunal with government appointed arbitrators, an appeal tribunal, and the obligation to disclose third party funding.

Political context: The EU's announcement that a proposed trade deal with the US (known as TTIP) would contain an ISDS mechanism led to public outcry across Europe. The investment chapter was put to public consultation in which 97% of respondents rejected ISDS. To allay public fears, the EU developed their ICS proposal. The EU is now leading efforts to establish a Multilateral Investment Court – a permanent, international body with much the same function as ICS.

Pros: ICS addresses some of the procedural shortcomings of the ad-hoc tribunals established under ISDS claims – such as the 'double-hatting' of corporate lawyers that represent investors in one case while serving as arbitrators in another. ICS contains some measures to limit 'treaty shopping'.

Cons: ICS retains vague and broadly interpreted investor protections like the right to 'Fair and Equitable Treatment' and protection from 'Indirect Expropriation'. ICS uses a broad definition of investment ("every kind of asset") and includes portfolio investments (hands-off investments where the investor has no control in the management of the enterprise). The most egregious ISDS cases – those which have attacked efforts to regulate coal power, fracking, pollution, destructive mines, health measures – could all be launched through the ICS system. ICS would still allow financial institutions to speculate on the outcome of cases.

The verdict: ICS does not resolve the fundamental concern with ISDS – the substantive, far reaching powers granted to corporations to sue governments over laws and decisions they do not like. The Multilateral Investment Court, if established, would entrench these powers at the international level and represent a step backwards for public law. ICS is less an alternative to ISDS than a reformulation.

Glossary

BIT: Bilateral Investment Treaty. The UK has 105 of these
Carve-out: A policy area to which a trade/investment agreement does not apply
CETA: EU-Canada Comprehensive Economic and Trade Agreement
FDI: Foreign Direct Investment. An investment made by a company or individual in one country in business interests in another country, either establishing a business or acquiring a controlling interest in a company
Fair and Equitable Treatment: An investment clause requiring governments to treat investors 'fairly' and not upset their 'legitimate expectations'. Contrast customary international law right to FET, with far-reaching rights under investment agreements.
ICS: The EU's Investment Court System.
Indirect Expropriation: Where a regulatory measure is considered to harm, affect or interfere with an investment
Investor: The terminology used to describe an entity with a private interest in a country – often a multinational corporation.
ISDS: Investor-State Dispute Settlement
M-N-BIT: Morocco-Nigeria BIT
MERCOSUR: A South American trading bloc.
NAFTA: North America Free Trade Agreement. An agreement between the USA, Canada and Mexico
Foreign Portfolio investment: Investment made as part of a portfolio. FPI doesn't offer control over the business entity. Investors usually expect to quickly realise a profit
Regulatory chill: Deterrence of public interest policy making
Right to regulate: The ability of a government to regulate without incurring liability under an international investment agreement
Sovereign Debt: Typically issued as bonds, sovereign debt is issued by the national government in a foreign currency in order to finance the issuing country's growth and development
Third party funding: Financing legal costs of an ISDS case in exchange for a portion of any eventual award
TTIP: Transatlantic Trade and Investment Partnership. A proposed free trade agreement between the USA and the EU

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