U.S. Experience Shows Structural Incentives Favoring Corporations in Investor-State System Not Fixable via Changes to Trade Pact Terms


The European Commission’s (EC) claim that threats posed by the investor-state dispute settlement (ISDS) system can be fixed by “improving” ISDS provisions in trade pacts has already been proved false. Current EC claims mirror U.S. government assurances made after a string of outrageous North American Free Trade Agreement (NAFTA) ISDS rulings forced significant “reforms” to ISDS terms in U.S. pacts starting in 2005. Yet, new analysis of these past efforts to rein in foreign firms’ expansive privileges under ISDS reveals that changes to trade pact ISDS language cannot address the fundamental problem with the ISDS structure. ISDS tribunals issuing rulings under the “reformed” provisions in U.S. pacts have systematically ignored the changes and issued the same outrageous rulings against non-discriminatory domestic environmental, health, and other policies.

The analysis shows how this outcome is due to problems inherent in the very structure of ISDS: tribunals have a structural incentive to boost their caseload and increase their earnings by using broad interpretations of foreign investors’ rights to rule in favor of corporations, which decide if and when to initiate future cases, and against governments. This fraught history of ISDS cases suggests that European policymakers – including the European Parliament’s Socialists & Democrats bloc and the French, Dutch and Austrian Parliaments – are correct to dismiss the EC’s attempt to mollify ballooning ISDS concerns, and that the public outcry against ISDS across Europe is wise.

Worse still, the ISDS tweaks the EC included in the EU-Canada Comprehensive Trade and Economic Agreement (CETA), which it also proposed to include in the Transatlantic Trade and Investment Partnership (TTIP), would actually make it even easier for U.S. firms to successfully attack European policies before ISDS tribunals. Under past deals, ISDS tribunals have had to create novel interpretations of vague foreign investor rights to rule against government policies. But the EC CETA text explicitly lists new ‘rights’ for investors, including by echoing one of the most overreaching past ISDS tribunal interpretations – based on imputing investors’ expectations – as a new basis that foreign firms could use to mount ISDS challenges. One veteran ISDS tribunalist has praised this approach, saying, “I love it, the new Canadian-EU treaty…we used to have to argue about all of those [foreign investor rights]…And now we have this great list. I just love it when they try to explain things.”

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Were such terms included in either TTIP or CETA, tens of thousands of U.S. firms could use these extraordinary rights to attack European public interest policies before extrajudicial tribunals.
CETA Would Expand the Special Privilege Foreign Corporations Use Most in ISDS Attacks, Exposing the EU to Claims that Policy Changes Frustrated Corporations’ “Expectations”

While “free trade” agreements (FTAs) and Bilateral Investment Treaties (BITs) typically include an array of broad rights available only to foreign investors, transnational corporations have relied on one such privilege more than any other to challenge health, financial, environmental and other public interest policies before ISDS tribunals. This oft-used special “right” is a government guarantee to afford foreign investors a “minimum standard of treatment,” including “fair and equitable treatment” (FET).

What does this vague government obligation mean? The interpretation is left to ISDS tribunals composed of three private lawyers who are not bound by precedent, the opinions of the governments that signed the agreements or any outside appeal. ISDS tribunals have interpreted the FET obligation to mean that investors must be guaranteed a stable regulatory framework that does not frustrate the expectations they held at the time they established their investment. That is, foreign investors must be compensated for nondiscriminatory changes to policies that occur after an investment is established. This extraordinary right is not available to domestic firms under most countries’ legal systems.

When the U.S. government had to defend itself against an ISDS challenge that tried to invoke this sweeping interpretation of FET, the government argued, “[I]f States were prohibited from regulating in any manner that frustrated expectations – or had to compensate for any diminution in profit – they would lose the power to regulate.” However, under the ISDS regime, “The power to regulate operates within the limits of rights conferred upon the investor,” according to a pro-ISDS expert’s synopsis of the FET standard. Indeed, ISDS tribunals have repeatedly decided that investors’ right to a stable regulatory framework trumps governments’ right to regulate. In three out of every four ISDS cases under U.S. FTAs and BITs in which the investor has “won,” the tribunal has ruled against the government on the basis of a FET or “minimum standard of treatment” violation.

Were TTIP or CETA to take effect with ISDS included, this commonly-used foreign investor privilege would likely become U.S. firms’ preferred basis for attacking EU and member state public interest policies. U.S. financial firms could challenge future European financial regulations before ISDS tribunals as violating their expectation of a stable regulatory framework. On the same, ample grounds, U.S. chemical firms could launch ISDS attacks against forthcoming European restrictions on chemicals that afflict human endocrine systems, U.S. tech companies could challenge new EU data protection rules before ISDS tribunals, and U.S. energy corporations could demand compensation from any EU member state that follows Germany’s lead in phasing out fossil fuel subsidies or nuclear power.

Tribunals Have Ignored Attempted ISDS “Fixes” Due to ISDS Structure that Incentivizes Rulings in Favor of Foreign Corporations and against Governments

In attempt to quell burgeoning opposition to ISDS in TTIP and CETA, the EC has stated an intent to “fix” ISDS, including by tweaking foreign firms’ expansive ISDS-granted rights, including FET. This is nothing new – the U.S. government already tried to use textual changes to rein in tribunals’ expansive interpretation of foreign firms’ rights under FET after a string of NAFTA rulings ordering foreign firms to be compensated by governments for non-discriminatory policies and
actions. But due to problems inherent in the very structure of ISDS, tribunals have repeatedly ignored such “fixes,” and will continue to do so. The ISDS structure creates a biased incentive system, described below, in which tribunalists can boost their caseload – and their earnings – by using broad interpretations of foreign investors’ rights to rule in favor of corporations and against governments.

Past attempts to “fix” ISDS, such as by narrowing foreign investor rights like FET, have failed. Since the U.S.-Central America Free Trade Agreement (CAFTA), U.S. trade agreements have included what was touted as “reformed” ISDS language, including several annexes that were promised to narrow vague obligations such as “minimum standard of treatment” and FET. By defining these foreign investor rights as derived from Customary International Law that “results from a general and consistent practice of States that they follow from a sense of legal obligation,” one annex attempted to constrain the “minimum standard of treatment” and FET obligations to the terms to which the signatory governments agreed and considered themselves bound, such as the provision of due process and police protection.17

But in both CAFTA cases in which tribunals have ruled on investors’ use of such provisions to make their case – Railroad Development Corporation (RDC) v. Guatemala and TECO Guatemala Holdings v. Guatemala – the tribunals ignored the reformed language and the annexes. In the RDC case, the three lawyers even paid little heed to the official submissions of four sovereign governments (including the U.S. government) highlighting the reforms and reinforcing that the “minimum standard of treatment” obligation should be interpreted narrowly.18 Instead, the RDC and TECO tribunals both relied on an expansive interpretation of that standard and foreign investor right, concocted from thin air by a previous ISDS tribunal in a NAFTA case, which included an obligation to honor investors’ expectations.19

Both ISDS tribunals ruled that Guatemala had violated the expanded obligation, and ordered the government to pay millions.20 Given that ISDS tribunals have repeatedly ignored attempts to rein in their discretion by modifying the FET standard, it is unclear why the EC believes that another modification in CETA or TTIP would produce different results.

Structural problems in the ISDS system make such changes to the underlying legal language in ISDS chapters of trade pacts ineffective. Under ISDS rules, only foreign investors can launch cases and also select one of the three tribunalists. (Imagine if the plaintiff was allowed to pick the judge in a domestic court case.) Thus, lawyers that create novel, expansive interpretations of FET and other foreign investor rights while serving as an ISDS tribunalist in one case can increase the number of investors interested in launching new cases and in picking them for future tribunalist gigs. (While governments can also select one of the tribunalists, these individuals do not have the same structural conflict of interest – interpreting investors’ rights narrowly may curry favor with governments, but it would diminish the number of firms interested in launching ISDS claims in the first place.) This helps explain why a few lawyers are repeatedly picked as ISDS tribunalists – just 15 lawyers have been involved in 55 percent of all public ISDS cases.21

ISDS tribunalists face few constraints in acting on this structural incentive to use wide notions of foreign investors’ rights to rule against governments. The absence of any system of precedent for ISDS rulings, or of governments’ rights to appeal the merits of cases, enables tribunalists to concoct fanciful interpretations of FET and order compensation for breaches of obligations to which signatory governments never agreed.
Revision of Foreign Corporations’ Preferred ISDS Privilege in CETA and TTIP Would Make It Even Easier for ISDS Tribunals to Rule against European Policies

While textual tweaks intended to narrow the overreaching interpretations of ISDS tribunals have failed, the specific FET tweaks supported by the EC would appear to move in the opposite direction, allowing ISDS tribunals to rule against governments without even needing to resort to broad interpretations. Indeed, the EC’s preferred version of FET would formalize the extraordinary rights that past ISDS tribunals have granted to foreign firms. Rather than constrain FET to basic rights such as due process and police protection, the FET language in the CETA investment chapter explicitly lists an array of broader rights that foreign firms could claim as part of FET.22 The EC included nearly identical language as reference text for TTIP in a 2014 public consultation on ISDS.23

For example, the FET definition in these two texts states that a government can be found to violate FET for “manifest arbitrariness,” an open-ended term that ISDS tribunals have interpreted as part of FET to rule against domestic measures taken in the public interest. In S.D. Myers v. Canada, an ISDS case brought by a U.S. firm under NAFTA, the tribunal interpreted FET as including a prohibition of “arbitrary” treatment.24 Using this definition, the tribunal ruled that Canada had violated its FET obligation by banning the export of a hazardous waste called polychlorinated biphenyls (PCB) that is proven to be toxic to humans and the environment.25 Though the PCB export ban complied with a multilateral treaty encouraging domestic treatment of toxic waste,26 the tribunal ordered the Canadian government to pay millions to the U.S. firm.27

The example shows how tribunals had to generate creative interpretations of FET under past ISDS-enforced agreements to claim that FET included such broad obligations as the prohibition of “arbitrary” policies. But under the FET language in the CETA investment chapter and the EC’s reference text for TTIP, such broad FET obligations would already be spelled out for tribunals. Indeed, veteran ISDS tribunalist Todd Weiler recently expressed appreciation for the EC’s new approach: “we used to just have fair and equitable and we had to argue what that meant. And now we have this great list. I just love it when they try to explain things.”28

Similarly, the CETA investment chapter and the EC’s reference language for TTIP explicitly allow ISDS tribunals to consider a foreign investor’s “legitimate expectation” in deciding whether the government has violated its FET obligations.29 As mentioned, the obligation to not frustrate investors’ expectations has been one of the most expansive interpretations of FET, frequently used to challenge nondiscriminatory domestic policies. For an ISDS tribunal to consider frustrated expectations as a potential FET violation, the EC’s definition only requires that the foreign firm relied on a “specific representation” from the government, which was later frustrated, in deciding to invest.30 An ISDS tribunal under CETA or TTIP could rule, for example, that an EU member state’s decision to respond to a financial crisis by restricting banks from dealing in risky derivatives frustrated the “legitimate expectation” of a U.S. bank doing business in the country. To support such a ruling, the tribunal could accept arguments from the U.S. bank that it had decided to establish its investment based on communications from an earlier administration, under a more lax regulatory framework, that the bank would be free to engage in derivative trading. Similar logic could be used in ISDS cases against European policy responses to climate crises, emerging food safety concerns, or other areas in which governments choose to alter policies, regardless of what earlier government officials may have said, to respond to emergent consumer demands or crises.
ENDNOTES


12 See Kenneth J. Vandevelde, “A Unified Theory of Fair and Equitable Treatment,” New York University Journal of International Law & Politics, 43:1, 2010. (“Yet, circumstances may arise where changes in the law may violate the fair and equitable treatment standard even in the absence of a promise or assurance to the contrary,” at 81.)


18 The U.S. government attempted to make clear the narrowness of the “minimum standard of treatment” standard in its official submission in the RDC case, stating, “These provisions [in the CAFTA annex] demonstrate the CAFTA-DR Parties’ express intent to incorporate the minimum standard of treatment required by customary international law as the standard for treatment in CAFTA-DR Article 10.5. Furthermore, they express an intent to guide the interpretation of that Article by the Parties’ understanding of customary international law, i.e., the law that develops from the practice and opinio juris of States themselves, rather than by interpretations of similar but differently worded treaty provisions. The burden is on the claimant to establish the existence and applicability of a relevant obligation under customary


25 59 FR 62785, 62877 (Dec. 6, 1994).


