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## **U.S.-Peru FTA Investor Rights: Lessons Learned and New Approaches Needed for Trans-Pacific Partnership**

During the debate surrounding the U.S.-Peru Free Trade Agreement (FTA) in 2007, many observers warned of the dangers associated with its extreme foreign investor rights and private “investor-state” enforcement that mirrored provisions in the North American Free Trade Agreement (NAFTA). These extreme investor provisions in the U.S.-Peru FTA empowered foreign firms to obtain compensation over any government action – health, environmental, zoning, labor, or other policies – that they claim undermined their “expected future profits”.

Unfortunately, the first “investor-state” claim brought against Peru under the U.S.-Peru FTA illustrates that the dangers of this system for Peru are not hypothetical. Renco Group Inc., a company owned by one of the richest men in the United States, is simultaneously using the investor-state system to demand \$800 million from Peru’s taxpayers<sup>1</sup> and to derail a U.S. court case seeking compensation for children in La Oroya injured by toxic contamination.<sup>2</sup> The dispute relates to a metal smelter in La Oroya, Peru owned by Renco subsidiary Doe Run. La Oroya has been designated as one of the top 10 most polluted sites in the world.<sup>3</sup> Particularly the community’s children are suffering from the effects of pollution levels far above international standards.<sup>4</sup>

Renco’s Peruvian affiliate promised to install sulfur plants to help remediate the environment by 2007 as part of an environmental agreement with the Peruvian government. Although it was out of compliance with this contractual obligation, the company sought (and Peru granted) two extensions to complete the project.<sup>5</sup> On December 29, 2010, Renco notified Peru that it was launching investor-state proceedings, alleging (among other claims) that Peru’s failure to grant a third extension of the environmental remediation obligations constitutes a violation of the firm’s new FTA rights as a foreign investor.

Renco v. Peru is a particularly egregious case, pitting one of the world’s wealthiest men, American Ira Rennert<sup>6</sup>, on one side, and children in a poor and polluted community on the other. The case illustrates two deeply worrying implications of investor-state arbitration. First, it shows that corporations will use investor-state cases to put pressure on governments to weaken environment and health policies. Second, corporations are increasingly attempting to evade justice in domestic courts through the investor-state mechanism. And, if Peru loses the case, its taxpayers must compensate Renco. Governments have already been ordered to pay more than \$2.5 billion in taxpayer funds to corporations in investor-state disputes under U.S. FTAs and

bilateral investment treaties (BITs) – almost 70 percent of this related to attacks on government’s environmental, oil, gas or mining policies.

The Renco Peru FTA investor-state case comes as both Americans and Peruvians are demanding change in natural resource, trade, and investment policies.<sup>7</sup> This memo outlines the key elements of the U.S.-Peru FTA investment model that must be changed to ensure a better balance between the interests of the public and of extractive industry companies and other foreign investors. U.S. and Peruvian negotiators have a unique opportunity to fix this problematic model in negotiations now underway for a possible Trans-Pacific Partnership (TPP) “free trade” agreement, which may subsume the bilateral FTA the two countries have in a broader eleven-nation pact.

### **Expansion of the investor-state system in the Trans-Pacific Partnership would expose Peru to enormous liability and cost**

Unfortunately, a leaked TPP negotiating text showed that the Obama administration is pushing not only the same dangerous investment terms found in the bilateral FTA, but an extension of these corporate rights. The TPP now includes eleven countries and would empower any corporation operating in these countries, including subsidiaries from additional countries, to skirt Peruvian law and courts to demand taxpayer compensation in foreign tribunals. Government actions deemed subject to these rules in recent investor-state cases now include the functioning of domestic court systems, denial of regulatory permits, environmental and health protections from toxics bans to cigarette packaging, natural resource management from water rights to mining policy, emergency regulatory measures taken during financial crises, and more. Many legal experts and policymakers in the U.S. and officials in other countries, however, are beginning to learn lessons from the mounting evidence of the excesses of the system and are proposing alternatives.

### **Lessons Learned: A worrying expansion of investor-state enforcement**

The leaked investment chapter of the Trans-Pacific Partnership shows that the TPP would expand the privileges afforded to foreign corporations by guaranteeing them special rights and privileges not provided to domestic firms under domestic law. As well as requiring government to provide special, preferential treatment to foreign investors, this regime would also empower foreign firms to privately enforce their new rights through what is called Investor-State Dispute Resolution. This system empowers corporations to sue governments —outside their domestic court systems—to demand taxpayer compensation for the corporations for any government action the corporations believe undermines their expected future profits or rights under the pact. These extreme rights and dual-track corporate justice systems pose an unparalleled threat to national sovereignty and democracy by elevating individual corporations and investors to equal standing with nations, empowering foreign private interests to directly enforce public treaties and skirt domestic courts.

Under this controversial investor-state system, foreign investors and corporations can sue governments in foreign tribunals staffed by three private sector lawyers operating under World Bank or United Nations investment arbitration rules. Most of the lawyers who serve on tribunals also represent corporations in attacking governments, which creates inherent conflicts of interest by allowing lawyers to rotate between roles as arbitrators and advocates for investors in a manner that would be unethical for judges in our domestic court systems. And, there are no formal conflict of interest laws. Thus, in a past investor-state case, one of the three investor-state tribunal members was on the board of directors of the investor bringing the case, and did not disclose this fact nor recuse herself. Yet, the large cash award ordered by this tribunal was allowed to stand.

The tribunals are empowered to award an unlimited amount of taxpayer dollars to corporations. If a corporation wins its private enforcement case, the taxpayers of the “losing” country must foot the bill – with the losing country’s treasury paying cash compensation to the winning corporation. Specialized private equity firms have sprung up to finance this system of raiding public treasury funds. There are extremely limited opportunities for “appeal” regardless of the arbitrariness of a specific award. Even when a government “wins,” they usually must pay for their own legal expenses and half of the tribunal’s costs. And, the fee structure for tribunalists, who bill large sums by the hour in contrast to domestic judges who are not paid for piecework, creates an incentive for lengthy proceedings even if in the end a case is dismissed.

The use of this “investor-state” regime is skyrocketing. Bilateral Investment Treaties (BITs) with investor-state enforcement have existed since the 1950s, but between 1972 and 2000 only about 50 disputes were resolved. While many of the early cases involved actual expropriation of factories or land seizure, over the past decade, a significant number of the cases have involved natural resource concession terms, environmental and health regulations and more. Since 2000, the number of new treaty-based investor-state cases launched each year has soared by 254%. The sudden flood of cases has persisted over the last decade, pushing the cumulative number of cases in 2011 to 450 - eight times the number of cases in 2000.<sup>8</sup>

### **Cash compensation to foreign investors paid by taxpayers**

To date more than \$808 million has been paid out to corporations and investors by governments under U.S. FTAs and BITs alone. Seventy percent of these cases pertained to challenges to governments’ natural resource and environmental policies. Tribunals have recently ordered governments to pay even more:

- The recent “win” by Exxon-Mobil of an investor-state NAFTA case attacking a Canadian province’s offshore oil and gas exploration regulations will add significantly to the \$365 million already paid to investors attacking environmental, zoning, timber and other policies under just US FTAs.

- ICSID recently ordered Ecuador to pay Occidental Petroleum \$1.8 *billion* over an oil concession contract fight under the U.S.-Ecuador Bilateral Investment treaty in the largest published single investor-state award to date.

These recent problematic and expensive rulings are not isolated cases. As more and more cases are filed and concluded, it has become evident that tribunals have increasingly interpreted the vague concepts of foreign investor rights in US FTAs very broadly, awarding millions in taxpayer compensation to corporations.

### **What are these dangerous investor rights?**

#### **The right to government compensation for regulatory costs - “Indirect expropriation”:**

While traditional “expropriations” involve government seizure of land or a factory, the notion of “indirect expropriation” in the U.S. investment model has been interpreted by tribunals to mean any regulation or other government action that reduces the value of a foreign investment. In the emblematic *Metalclad v. Mexico* case, U.S. toxic waste disposal firm Metalclad challenged a Mexican municipality’s refusal to grant a construction permit for a toxic waste facility unless the firm cleaned up existing toxic waste problems. The facility had been closed by the government because of the contamination it caused when it was previously owned by a Mexican company, which the U.S. firm was aware of when it purchased the facility. A NAFTA tribunal ruled that the denial of the construction permit to the U.S. foreign investor was tantamount to an “indirect” expropriation because it undermined the value of the firm’s investment - even though the government’s refusal to allow the facility to operate until it was cleaned up applied to domestic and foreign investors alike. Mexican taxpayers were forced to pay Metalclad \$15.6 million.

**“Minimum standard of treatment”:** Vaguely worded provisions guaranteeing foreign investors a “minimum standard of treatment” (MST), including “fair and equitable treatment,” open the door to investor-state claims over a wide range of government measures that are otherwise permissible under the U.S. Constitution and other nations’ legal systems. Investor-state tribunals have used this concept to order governments to pay corporations compensation if a domestic law is changed or a new policy is created – even if it applies to foreign and domestic firms equally. Tribunals have used the Minimum Standard of Treatment obligation to fabricate theories about investor’s “expectations” for a “stable regulatory environment” being undermined by such changes to policies of general application in response to changing circumstances, such as financial crises, or in response to public demands.<sup>9</sup> That is to say that under these rules foreign firms are guaranteed insulation against change, no matter if it comes from a democratic process such as an election or an act of Congress. For instance, in the NAFTA investor-state case, *SD Meyers v. Canada*, a tribunal held that Canada’s ban of cross-border toxic waste shipments which it enacted to implement its obligations under the Basel Convention (a multilateral environmental agreement) violated the firm’s NAFTA-guaranteed minimum standard of treatment. Canada had to pay the firm \$20 million in compensation. Fully 74 percent of

“successful” investor claims under U.S. Free Trade Agreements (FTAs) and Bilateral Investment Treaties (BITs) have found “fair and equitable treatment” violations, making this by far the most successful claim for investors against states.

Even legal experts in official circles became concerned about the breadth of tribunals’ interpretations of these concepts. So, starting with the 2005 Central America Free Trade Agreement (CAFTA), the United States claimed to narrow the scope of these concepts by adding an interpretative annex which was also included the U.S.-Peru FTA. Unfortunately, the first ruling on this concept by a tribunal under CAFTA demonstrated that the annex does not foreclose the dangerous problem of investor-state tribunals generating fanciful notions of new obligations countries owe foreign investors and then ordering countries to pay corporations for violations of rules to which they never agreed when they signed FTAs and BITs.

In June of 2012 an ICSID tribunal produced an \$11.3 million judgment in favor of Railroad Development Corporation (RDC) against Guatemala. While RDC had received a concession to rehabilitate Guatemala’s railroad network in five phases, the company had only completed the first phase after eight years of operation. Unsatisfied with the slow progress, in 2006 Guatemala declared parts of the RDC contract “injurious to the interests of the state” (*lesivo*), the first step in an administrative legal process to determine whether a contract should be revoked. Although RDC continued to enjoy its rights under the contract and continued to make money from it, the tribunal held that the very process of initiating the legal review violated RDC’s minimum standard of “fair and equitable treatment.” To get to this outlandish decision, the tribunal simply ignored CAFTA’s interpretative annex that required that the fair and equitable treatment standard must be analyzed according to Customary International Law. Under that review, a violation of fair and equitable treatment means denial of justice – an investor being denied access to courts or other forms of due process. Yet, while RDC was attacking Guatemala in the investor-state tribunal, it was also simultaneously engaging in the domestic Guatemalan administrative review and court review processes triggered by the *lesivo* notification! And, the United States, as well as three other of the CAFTA countries, submitted briefs in the case stating that the tribunal had to base its analysis on the Annex and Customary International Law. Instead, the tribunal borrowed a broad interpretation of the Fair and Equitable Treatment standard cooked up by another panel of three private sector attorneys in the NAFTA investor case *Waste Management II* and used that expansive interpretation to declare that Guatemala had violated the rules.<sup>10</sup>

### **Threats beyond cash compensation: important policies chilled, threats lead to laws being eliminated**

Cash compensation awarded to corporations by taxpayers is only one of the threats of the system. Increasingly, investor-state cases are also being used as a form of rough bargaining to pressure governments to submit to the corporations’ demands or to chill new initiatives before they are implemented.

- As described above, in the Renco v. Peru case, Renco Group has not moved forward with its investor-state case after initially filing it in 2010. Rather, the U.S. corporation has used the threat of the arbitration to pressure the Peruvian government to grant an additional extension for its responsibility to remediate pollution in La Oroya and to delay a U.S. court case seeking compensation for pollution victims.
- Canada reversed a nationwide ban on MMT, a gasoline additive banned in many U.S. states as a probable carcinogen, after the U.S. Ethyl Corporation filed a NAFTA Investor-State case.
- In El Salvador, where 98% of the country's water is polluted in part due to past metallic mining, a national debate on the future of metallic mining has been heavily influenced by investor-state cases that have been launched by Canadian and U.S. mining companies. While an investor-state tribunal dismissed a case by U.S.-based Commerce Group, the company has filed for an "annulment" of this ruling. Canada-based Pacific Rim Mining Company demanded over \$200 million in compensation from the government for granting the company an exploitation permit (after the company failed to complete the appropriate steps). An ICSID tribunal has allowed part of that case to go forward on the merits. There are 29 foreign mining companies with applications for mining permits filed who are watching these cases closely. The message to El Salvador as the legislature debates its mining policy is: "If you pass a law that protects your country's water over the right of foreign investors to extract precious metals, know you will spend millions on lawyers and tribunal fees even if you win all the potential investor-state cases."
- The two recent investor-state attacks by Phillip Morris on Uruguayan and Australian tobacco control policies through similar treaties opened yet another front in the use of this regime to attack governmental regulatory policy space far afield from any traditional notion of expropriation of land or factories. Countries seeking to implement their commitments on the UN Framework Convention on Tobacco Control now must worry about having to defend themselves from investor-state claims from Big Tobacco.

In several instances, arbitral tribunals have gone beyond awards of cash damages and issued injunctive relief for corporations that creates severe conflicts of law. In the Chevron v. Ecuador investor-state case under the U.S.-Ecuador Bilateral Investment Treaty, a tribunal of three private sector investment lawyers awarded an interim ruling against Ecuador, ordering Ecuador's government to halt enforcement of a domestic appellate court ruling against Chevron in the Amazon pollution case. The tribunal announced that damages in the historic case involving 18 years of U.S. and Ecuadorian court rulings against Chevron could not be paid until the tribunal had reviewed the merits of the case and decided if the Ecuadorian high court ruling was legitimate. If Ecuador's president complies with this order, he will violate Ecuador's constitutional separation of powers system. Chevron no longer has assets in Ecuador, so lawyers representing the indigenous communities that won this historic multi-billion environmental

damages award must collect against Chevron in countries where the firm has assets. However, it remains to be seen if other governments will follow the tribunal's order and thus allow Chevron to escape liability for its devastation of wide swaths of Ecuador's Amazon through this investor-state system.

Either by winning such an investor-state attack and collecting millions in compensation or by preemptively chilling government actions to address critical public needs, these international investor rights and their private investor-state enforcement now impose an outer bound of the possible for progressive reform for communities and countries setting policies related to health, the environment, water, or other natural resources.

### **Time overdue for a new approach**

The worrying expansion of the investor-state system and the increasing liability on governments in the course of protecting consumers, health, and the environment has led many legal experts and some governments to rethink their participation in the investor-state system. While there is no evidence that signing investment treaties with investor-state enforcement increases foreign direct investment<sup>11</sup>, the risks to states is becoming clearer. Brazil, which does not include investor-state enforcement in its treaties, has the highest level of foreign direct investment in Latin America. Australia has decided not to submit itself to investor-state enforcement in the TPP. South Africa and India have undertaken reviews of their investment regime with an eye toward renegotiating the terms. The *Renco v. Peru* case offers a cautionary tale to Peruvian policymakers to not expand Peru's vulnerability to similar attacks on its domestic policymaking by new foreign companies in the TPP.

**A new approach would require not replicating key elements of damaging U.S. trade agreement investment rules in the TPP or future trade and investment pacts. Among others, these elements include:**

#### **1. Stop the investor-state dispute settlement mechanism's corporate attacks**

The international tribunals that currently rule over investor-state claims lack public accountability, standard judicial ethics rules, and appeals processes. This system should be replaced with a state-to-state mechanism to guarantee the crucial role of governments in protecting the public interest. If an investment agreement is to permit any access to any arbitral tribunal mechanism, investors should at least be required to exhaust domestic remedies before proceeding to international tribunals and a diplomatic screen must be added to prevent frivolous claims or claims which otherwise may cause serious public harm.

#### **2. Eliminate "minimum standard of treatment" that freezes regulatory improvements**

Vaguely worded provisions guaranteeing foreign investors a "minimum standard of treatment" (MST), including "fair and equitable treatment," open the door to investor-state claims over a wide range of government measures that are otherwise permissible under the U.S. Constitution

and other nations' legal systems. In the investor-state case *Glamis Gold v. the United States*, the United States successfully persuaded the tribunal to accept a relatively narrow interpretation of the MST principle. But in cases since then under U.S. FTAs and BIT tribunals have created new obligations using these concepts and ordered governments to compensate corporations for actions that do not violate the Customary International Law interpretations of these terms. Since the tribunals are not required to follow judicial precedent, at a minimum, the *Glamis Gold* interpretation should be codified in the TPP text to prevent decisions in future cases from having overly broad interpretations that undermine responsible policymaking.

**3. Remove the “indirect expropriation” rule that permits challenges of non-discriminatory policies alleged to affect profits.**

In the past, expropriation applied to the physical taking of property, such as when a government expropriates a house to make way for a highway. Under most international investment agreements today, investors are also protected against “indirect” expropriation, which can be interpreted to mean regulations and other government actions that reduce the value of a foreign investment. While international arbitration tribunals cannot force a government to repeal laws or regulations, the threat of massive damages awards can put a “chilling effect” on policymaking. The TPP should clarify that regulatory measures that do not transfer ownership of the investment do not constitute acts of indirect expropriation.

**4. Restrict the definition of investment to “real property” to eliminate broad attacks.**

Any investment rules in a TPP should only cover real property rights and other specific interests in property that are protected under the U.S. Constitution and other signatory nations' legal systems. Government procurement and natural resource concession contracts, regulatory permits, intellectual property rights, financial instruments (such as derivatives), and vague notions of “assumption of risk” must be excluded from the definition of covered investments.

**5. Ensure that policies to prevent and mitigate financial crises are not subject to attack.**

Although many governments have used capital controls effectively to avoid the worst effects of financial crises, U.S. FTAs and BITs still include sweeping restrictions on this policy tool. Existing rules could also thwart efforts to adopt small taxes on foreign exchange transactions and trades of other financial instruments aimed at curbing excessive speculation. The TPP should include safeguards for financial crises that are not subject to investor-state dispute settlement. It should also exclude short-term investments (“hot money”) and sovereign debt from the definition of investment.

**6. Include an explicit general exception for environmental and labor protections.**

Some FTAs include an “Investment and Environment” provision that appears to be intended to safeguard environmental regulations from investor-state claims. However, 70 percent of cases under US FTAs and BITs have challenged countries' environmental policies. The TPP should include a general exception for measures related to the protection of health, safety and the environment; natural resource conservation; and international human and labor rights.

## 7. Close the massive subsidiary loophole.

Many U.S. FTAs and BITs contain a loophole that allows corporations to bypass their own country's domestic courts by filing investor-state claims through foreign subsidiaries located in a FTA or BIT partner nation. This is explicitly permitted in many agreements, so long as the corporation has "substantial business activities" in the other country. Since "substantial" is not clearly defined, a company can set up a storefront subsidiary in one country for the sole purpose of taking advantage of the FTA to sue in another country. This "forum shopping" has led to Phillip Morris (a U.S. company) to claim to be a Swiss corporation to sue Uruguay under a Swiss-Uruguay BIT and to claim to be a Hong Kong company to sue Australia under a Hong Kong-Australia BIT. This should not be permitted in the TPP.

## ENDNOTES

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<sup>1</sup> The Renco Group, Inc. v. The Republic of Peru, Claimant's Notice of Intent to Commence Arbitration under United States – Peru Trade Promotion Agreement, Dec. 29, 2010, at para 10. Available at: <http://italaw.com/sites/default/files/case-documents/ita0713.pdf>.

<sup>2</sup> See Public Citizen's memo, "Renco Uses U.S.-Peru FTA to Evade Justice for La Oroya Pollution." Available at: <http://www.citizen.org/documents/renco-la-oroya-memo.pdf>.

<sup>3</sup> Blacksmith Institute, "The Top Ten of The Dirty Dozen", Project of The Blacksmith Institute, September 2007, at 6. <http://www.worstpolluted.org/reports/file/2007%20Report%20updated%202009.pdf> and Blacksmith Institute, "The Worlds Worst Polluters: The Top Ten" Project of the Blacksmith Institute, October 2006. <http://www.worstpolluted.org/reports/file/10worst2.pdf>.

<sup>4</sup> Anna K. Cederstav, Alberto Barandiarán, "La Oroya Cannot Wait" AIDA & SPDA Publication, September 2002, at 25, 41-48. Available at: [http://www.aida-americas.org/sites/default/files/La\\_Oroya\\_Cannot\\_Wait\\_1\\_0.pdf](http://www.aida-americas.org/sites/default/files/La_Oroya_Cannot_Wait_1_0.pdf).

<sup>5</sup> See Sections I-IV of Public Citizen's memo on the Renco case: Todd Tucker, "Renco Group Uses Trade Pact Foreign Investor Provisions to Chill Peru's Environment and Health Policy, Undermine Justice," March 2012, at 14-22. Available at: <http://www.citizen.org/documents/renco-memo-03-12.pdf>.

<sup>6</sup> "Forbes 400 Richest Americans: Ira Rennert," *Forbes*, published Sept. 2012, accessed Nov. 20, 2012. Available at: <http://www.forbes.com/profile/ira-rennert/>.

<sup>7</sup> See Section VIII of Public Citizen's memo on the Renco case: Todd Tucker, "Renco Group Uses Trade Pact Foreign Investor Provisions to Chill Peru's Environment and Health Policy, Undermine Justice," March 2012, at 14-22. Available at: <http://www.citizen.org/documents/renco-memo-03-12.pdf>.

<sup>8</sup> UNCTAD, "IIA Issues Note," April 2012. Available at: [http://unctad.org/en/PublicationsLibrary/webdiaeia2012d10\\_en.pdf](http://unctad.org/en/PublicationsLibrary/webdiaeia2012d10_en.pdf).

<sup>9</sup> See, for example, *Tecmed v. Mexico*, and *El Paso v. Argentina*.

<sup>10</sup> *Railroad Development Corporation (RDC) v. Republic of Guatemala*, ICSID Case No. ARB/07/23, Award (June 29, 2012), at para. 219. Available at: <http://italaw.com/sites/default/files/case-documents/ita1051.pdf>.

<sup>11</sup> Kevin P. Gallagher, Roberto Porzecanski, Andrés López, and Lyuba Zarsky. Foreign Investment and Sustainable Development: Lessons from the Americas. 2008. Available at: <http://www.ase.tufts.edu/gdae/Pubs/rp/FDIWorkingGroupReportMay08.pdf>.