# Transforming the IIA Regime: Exiting the Unnecessary, Damaging Investor-State Dispute Settlement System[1]

## Research project

Public Citizen, Global Trade Watch Division, 20 February 2014. The recommendations in this submission are based on the research and analysis contained in recent Public Citiyen reports on topcis including:

- Public Citizen. Myths and Omissions: Unpacking Obama Administration Defenses of Investor-State Corporate Privileges, October 2014. Available at: http://www.citizen.org/documents/ISDS-and-TAFTA.pdf
- Public Citizen. Case Studies: Investor-State Attacks on the Public Interest, October 2014. Available at: http://www.citizen.org/documents/egregious-investor-state-attacks-case-studies.pdf

**Key recommendations:**

- While technical reforms could, at best, improve the ISDS regime on the margins, moving away from the regime altogether is the wisest course for governments, because (1) states have not received tangible benefits from ISDS agreements while costs have been tangible and substantial, and (2) proposed reforms would not be sufficient to protect governments from mounting ISDS liability or to eliminate the inherent conflicts of interest in the system.
- Based on Public Citizen's extensive analysis of the jurisprudence of the ISDS regime, and the successful results for governments that have chosen to exit the regime, we join the chorus of government officials, civil society organizations, trade unions, small businesses, academics and jurists that call on governments to stop the spread of the ISDS regime by not signing new ISDS-enforced IIAs and to exit or renegotiate any existing agreements that include ISDS.

**Overview:**

The investor-state dispute settlement (ISDS) system, included in various international investment agreements (IIAs), fundamentally shifts the balance of power among investors, States and the general public, creating an enforceable global governance regime that formally prioritizes corporate rights over the right of governments to regulate. Public Citizen, along with partners around the globe, has documented the mounting costs of the ISDS regime to public interest policymaking, rule of law, democratic governance and development.[1] Governments have rightly begun to reject further expansion of such a controversial system and to exit or renegotiate IIAs that include ISDS.

**While technical reforms could, at best, improve the ISDS regime on the margins, moving away from the regime altogether is the wisest course for governments, because (1) states have not received tangible benefits from ISDS agreements while costs have been tangible and substantial, and (2) proposed reforms would not be sufficient to protect governments from mounting ISDS liability or to eliminate the inherent conflicts of interest in the system.**

**States do not receive tangible benefits from ISDS agreements:**

**The purported benefit of ISDS – increased foreign direct investment (FDI) – remains elusive**. Numerous studies have examined whether countries have seen an increase in FDI as a result of being willing to sign pacts with ISDS enforcement. Summarizing the studies' contradictory results, the United Nations Conference on Trade and Development (UNCTAD) concluded in September 2014, "[T]he current state of the research is unable to fully explain the determinants of FDI, and, in particular, the effects of [IIAs] on FDI."[2] UNCTAD delivered that synopsis alongside its

[1] 1 The opinions expressed in this paper are those of the author and do not necessarily reflect the views of the UNCTAD Secretariat or its Member States.

own study finding that “results do not support the hypothesis that [IIAs] foster bilateral FDI.”[3] A 2010 survey of the 200 largest U.S. corporations corroborated these results, finding that leading U.S. firms were relatively unfamiliar with BITs and considered such treaties to be relatively unimportant in their foreign investment decisions.[4] While countries bound by ISDS pacts have not seen significant FDI increases, countries without such pacts have not lacked for foreign investment. Brazil, for example, has consistently rebuffed IIAs with ISDS provisions,[5] yet remains the world’s fourth most popular destination for FDI and the leading destination of FDI in Latin America, where most other countries have signed numerous pacts with ISDS terms.[6]

**Governments that have withdrawn from the ISDS system have reduced their liability and protected policy space without experiencing adverse impacts on investment or development.** As promised benefits of ISDS have proven illusory while tangible costs to taxpayers and safeguards have grown, an increasing number of governments have begun to reject the investor-state regime. South Africa[7] and Indonesia[8] have started terminating all bilateral investment treaties (BIT) that contain ISDS provisions. After already terminating ten BITs,[9] Ecuador is now conducting an audit of many of its remaining pacts to determine if they are in the national interest.[10] India’s Ministry of Commerce and Industry has recommended that the government terminate all of India’s 83 Bilateral Investment Promotion and Protection Agreements, while the Department of Economic Affairs has called for these ISDS pacts to be reviewed and renegotiated.[11] Venezuela and Bolivia have withdrawn from the World Bank forum where most investor-state cases are tried.[12]

Developing countries that have decided to terminate their IIAs have not seen FDI inflows decline. Indeed, as they have moved to exit the ISDS system, foreign investment has actually grown. Ecuador’s net FDI flows with countries with which it has terminated BITs have shifted from a combined $52 million net *outflow* in the year of IIA termination to a combined $110 million net *inflow* in 2013.[13] And as South Africa began terminating its BITs with various EU nations in 2013, the country’s FDI inflows doubled to $10.3 billion. In fact, South Africa received more FDI than any other African country amid its announcements of IIA terminations in 2013, while FDI inflows diminished for other growing African economies such as Nigeria and Ghana (both of which have an array of IIAs in force).[14]

**Technical reforms to IIAs would not protect states from liability or rectify the system’s inherent conflict of interest:**

**Purported safeguards and explanatory annexes added to some IIAs in recent years have failed to prevent ISDS tribunals from exercising enormous discretion to impose on governments obligations that they never undertook when signing agreements.** The U.S. government’s attempt to “include stricter definitions…of what is required for successful claims”[15] in recent pacts has failed to stop tribunals from using increasingly expansive interpretations of foreign investors’ rights to side with corporations in ISDS challenges to public interest policies. In the U.S.-Central America Free Trade Agreement (CAFTA), the Parties inserted an annex[16] that attempted to narrow the vague obligation for States to guarantee foreign investors a “minimum standard of treatment,” which a litany of tribunals had interpreted as an obligation for the government to not frustrate investors’ expectations, for instance by improving environmental or health laws after an investment was established. However, in two of the first investor-state cases brought under CAFTA –*RDC v. Guatemala* and *TECO v. Guatemala* — the tribunals simply ignored the annex’s narrower definition of “minimum standard of treatment.” They also paid little heed to the submissions of the governments that negotiated CAFTA, which argued that the “minimum standard of treatment” obligation should be narrowly defined according to State practice. Instead, the *RDC* and *TECO* tribunals both skipped any examination of State practice and relied on an expansive interpretation of that standard, concocted by a previous investor-state tribunal, which included an obligation to honor investors’ expectations.[17] Both ISDS tribunals ruled that Guatemala had violated the expanded obligation, and ordered the government to pay millions.

The U.S, government also included a “safeguard” provision in recent pacts to dispense with frivolous investor-state claims. The relevant language in the 2012 U.S. model BIT provides for expedited consideration of arguments from the government that a case should be terminated because the legal claim used by the foreign corporation to attack its policies is not permitted under the treaty's sweeping investor protections.[18] One problem is that tribunalists with financial incentives to continue cases are the ones who decide whether to accept such arguments for termination. Another problem is that many investor-state claims *do* in fact fall within the wide ambit of the investor privileges found in U.S. IIAs. That is because the pacts grant broad rights to investors and give ample discretion to tribunals to interpret those rights as far-reaching restrictions on States' prerogative to regulate in the public interest.

**The very structure of the ISDS regime gives rise to conflicts of interest that would not be remediated by enhancement of the weak "conflict of interest" rules for tribunalists.** The actual conflict of interest rules that apply under many pacts containing ISDS are notably weak. But there are more fundamental problems. The entire structure of ISDS has created a biased incentive system in which tribunalists can boost their caseload by using broad interpretations of foreign investors' rights to rule in favor of corporations and against governments, and boost their earnings by dragging cases out for years. ISDS is neither fair nor neutral, not because of a few compromised tribunalists, but due to core design flaws.

Under ISDS rules, only foreign investors can launch cases and also select one of the three tribunalists. (By contrast, in domestic courts, judges are assigned to a case, not hired by the plaintiff.) Thus, ISDS lawyers that create novel, expansive interpretations of foreign investors' rights while serving as a tribunalist in one case can increase the number of investors interested in launching new cases and enhance the likelihood of their selection by investors for future tribunals. (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.[19] The absence of any system of precedent for ISDS rulings, or of governments' rights to appeal the merits of cases, further enables tribunalists to concoct ever more fanciful interpretations of ISDS-enforced agreements and order compensation for breaches of obligations to which signatory governments never agreed.

**Transparency rules cannot hold accountable tribunals that remain unrestrained by precedent, States' opinions or substantive appeals.** Transparency is a necessary, but not sufficient, condition for reining in investor-state tribunals' ability to fabricate new obligations for States and then rule against public interest policies as violations of the novel obligations. As investor-state documents have become more publicly available, tribunals have not indicated greater hesitance to use overreaching interpretations of investors' rights. Documents were generally made available in the recent *Occidental v. Ecuador* case brought under the U.S.-Ecuador BIT. That includes the publicly-available 2012 award in which the tribunalists concocted a new obligation for Ecuador to respond proportionally to Occidental's breach of the law, deemed themselves the arbiters of proportionality, and ordered the government to pay $2.3 billion for violating the creative obligation.[20]

**Recommendation:**

Based on Public Citizen's extensive analysis of the jurisprudence of the ISDS regime, and the successful results for governments that have chosen to exit the regime, we join the chorus of government officials, civil society organizations, trade unions, small businesses, academics and jurists that call on governments to stop the spread of the ISDS regime by not signing new ISDS-enforced IIAs and to exit or renegotiate any existing agreements that include ISDS.

**ENDNOTES**

[1] These conclusions are supported by recent Public Citizen reports: *Myths and Omissions: Unpacking Obama Administration Defenses of Investor-State Corporate Privileges*, October 2014. Available at: http://www.citizen.org/documents/ISDS-and-TAFTA.pdf and *Case Studies: Investor-State Attacks on the Public Interest.* Available at: http://www.citizen.org/documents/egregious-investor-state-attacks-case-studies.pdf

[2] The report further advised, "Thus developing-country policymakers should not assume that signing up to BITs will boost FDI. Indeed, they should remain cautious about any kind of recommendation to actively pursue BITs." United Nations Conference on Trade and Development, *Trade and Development Report, 2014*, (New York: United Nations, 2014), at 159. Available at: http://unctad.org/en/PublicationsLibrary/tdr2014_en.pdf.

[3] United Nations Conference on Trade and Development, *Trade and Development Report, 2014*, (New York: United Nations, 2014), at 159. Available at: http://unctad.org/en/PublicationsLibrary/tdr2014_en.pdf.

[4] Jason Webb Yackee, "Do Bilateral Investment Treaties Promote Foreign Direct Investment? Some Hints from Alternative Evidence," *Virginia Journal of International Law*, 51:2, 2011. Available at: http://www.vjil.org/assets/pdfs/vol51/issue2/Yackee.pdf.

[5] While Brazil has signed various BITs, none have been ratified or entered into force. United Nations Conference on Trade and Development, "Full list of Bilateral Investment Agreements concluded: Brazil," UNCTAD factsheet, June 1, 2013. Available at: http://unctad.org/Sections/dite_pcbb/docs/bits_brazil.pdf.

[6] Among UN-recognized countries, Brazil was the fourth-largest recipient of FDI inflows in 2013, after the United States, China and Russia. As a share of GDP, Brazil's 2013 FDI inflows exceeded those of the United States. United Nations Conference on Trade and Development, "Inward and outward foreign direct investment flows, annual, 1970-2012," UNCTADStat, 2013. Available at: http://unctadstat.unctad.org/TableViewer/tableView.aspx.

[7] Leandi Kolver, "SA proceeds with termination of bilateral investment treaties," *Engineering News*, October 21, 2013. Available at: http://www.engineeringnews.co.za/article/sa-proceeds-with-termination-of-bilateral-investment-treaties-2013-10-21.

[8] Ben Bland and Shawn Donnan, "Indonesia to terminate more than 60 bilateral investment treaties," *Financial Times*, March 26, 2014. Available at: http://www.ft.com/cms/s/0/3755c1b2-b4e2-11e3-af92-00144feabdc0.html#axzz30ezmIt5L.

[9] Latin Arbitration Law, "Ecuador Evaluates Investment Treaty Framework," LAL brief, 2014, accessed September 5, 2014. Available at: http://www.latinarbitrationlaw.com/ecuador-evaluates-investment-treaty-framework/.

[10] Mercedes Alvaro, "Ecuador Establishes Commission To Audit Investment Treaties," *The Wall Street Journal*, October 8, 2013. Available at: http://online.wsj.com/article/BT-CO-20131008-712214.html.

[11] Arun S, "Ministries for scrapping of bilateral investment pacts," *The Financial Express*, July 14, 2014. Available at: http://www.financialexpress.com/news/ministries-for-scrapping-of-bilateral-investment-pacts/1269646/1.

[12] Sergey Ripinsky, "Venezuela's Withdrawal From ICSID: What it Does and Does Not Achieve," International Institute for Sustainable Development article, April 13, 2012. Available at: http://www.iisd.org/itn/2012/04/13/venezuelas-withdrawal-from-icsid-what-it-does-and-does-not-achieve.

[13] Of the 10 BITs that Ecuador has terminated, four are with countries that represent significant FDI flows for Ecuador: the Dominican Republic, Finland, Romania and Uruguay. This statistic is a sum of Ecuador's inflation-adjusted net FDI flow with each of these four countries in the year of each country's BIT termination and in 2013. Banco Central del Ecuador, "Inversión Extranjera Directa por País de Origen," 2014, accessed September 5, 2014. Available at: http://www.bce.fin.ec/index.php/component/k2/item/298-inversi%C3%B3n-extranjera-directa.

[14] Tosin Sulaiman, "South Africa was continent's top FDI recipient in 2013," *Reuters*, January 28, 2014. Available at: http://www.reuters.com/article/2014/01/28/africa-fdi-idUSL5N0L23YF20140128.

[15] Office of the U.S. Trade Representative, "The Facts on Investor-State Dispute Settlement: Safeguarding the Public Interest and Protecting Investors," USTR blog post, March 27, 2014. Available at: http://www.ustr.gov/about-us/press-office/blog/2014/March/Facts-Investor-State%20Dispute-Settlement-Safeguarding-Public-Interest-Protecting-Investors.

[16] Dominican Republic – Central America – United States Free Trade Agreement, ch. 10 (Annex 10-B), August 5, 2004, Pub. L. No. 109-53, 119 Stat. 462 (2005), at 10-27.

[17] *Railroad Development Corporation 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. *TECO Guatemala Holdings, LLC v. Republic of Guatemala*, ICSID Case No. ARB/10/23, Award (December 19, 2013), at para. 455. Available at: http://italaw.com/sites/default/files/case-documents/italaw3035.pdf.

[18] 2012 U.S. Model Bilateral Investment Treaty, U.S. Department of State, 2012, at Article 28. Available at: http://www.state.gov/documents/organization/188371.pdf.

[19] Pia Eberhardt and Cecilia Olivet, "Profiting from Injustice," Transnational Institute and Corporate Europe Observatory report, November 2012, at 38. Available at: http://www.tni.org/sites/www.tni.org/files/download/profitingfrominjustice.pdf.

[20] *See* Lori Wallach and Ben Beachy, "*Occidental v. Ecuador* Award Spotlights Perils of Investor-State System: Tribunal Fabricated a Proportionality Test to Further Extend the FET Obligation and Used 'Egregious' Damages Logic to Hit Ecuador with $2.4 Billion Penalty in Largest Ever ICSID Award," PC memo, November 21, 2012. Available at: http://www.citizen.org/documents/oxy-v-ecuador-memo.pdf.