European Commission

Fact sheet

Investment Protection and Investor-to-State Dispute Settlement in EU agreements

November 2013

Executive summary

A new start for investment and investment protection

Investment protection provisions, including investor-state dispute settlement are important for investment flows. They have generally worked well. However, the system needs **improvements**. These relate to finding a better balance between the **right of states to regulate** and the **need to protect investors**, as well as to making sure the arbitration system itself is above reproach e.g. transparency, arbitrator appointments and costs of the proceedings.

The Lisbon Treaty made negotiating investment agreements an EU competence. It provides a unique opportunity to set a new agenda for investment protection and investor state dispute settlement provisions. This also reflects the **views expressed by the European Parliament** in its Resolution on the future of European international investment policy adopted on 6 April 2011.

The EU can draw on lessons from how the arbitration system has worked so far including from the existing 1400 investment protection agreements of Member States in order to make changes to the system of investment protection. With its global economic weight, the EU is in a strong position to convince its trading partners of the need for clearer and better standards. The primary vehicle for this will be through **bilateral** negotiations with third countries. We also have the possibility to influence the **multilateral** context, for example through the United Nations Commission on International Trade Law (UNCITRAL) – where we have created new rules on transparency that will apply beyond the EU's own investment agreements.

Rebalancing the system – a two-pronged approach

The Commission is working to bring improvements on two fronts:

(1) **Clarifying and improving investment protection rules:**

- **Right to regulate:** the EU agreements reaffirm the right of the Parties to regulate to pursue legitimate public policy objectives;
- '**Indirect expropriation**': future EU agreements will provide a detailed set of provisions giving guidance to arbitrators on how to decide whether or not a government measure constitutes indirect expropriation. In particular, when the state is protecting the public interest in a non-discriminatory way, the right of the state to regulate should prevail over the economic impact of those measures on the investor.
- '**Fair and equitable treatment**' – a standard very frequently invoked by investors – is not clearly defined. As a result, tribunals have had significant leeway in interpreting this in a manner that has been seen as giving too many or too few rights to investors. In EU agreements, the standard will set out precisely what elements are covered and thus prohibited

And (2) **Improving how the dispute settlement system operates**.

- ➢ Preventing investors from bringing multiple or frivolous claims (investor who loses case will be obliged pay **all litigation costs** including those of the state)
- ➢ Making the arbitration system **more transparent**: documents available to the public, access to hearings and allow interested parties (e.g. NGOs) to make submissions
- ➢ Dealing with conflicts of interests and consistency of arbitral awards (e.g. introduction of a **binding code of conduct** for arbitrators)
- ➢ Introducing **safeguards for Parties** (this will allow states to maintain control over how the investment provisions are being interpreted)

Such improvements will address concerns raised that investment protection rules may have a negative effect on states' right to regulate. They should, amongst other things, ensure that legitimate government public policy decisions cannot be successfully challenged.

The Commission has already introduced these improvements in the EU free trade agreement with Canada and is negotiating or will negotiate similar improvements in its agreements with other countries.

I. Introduction

This outline explains why investment protection provisions are necessary and looks at lessons learned from how investment protection has worked in the past. It presents the concrete improvements made by the Commission to investment provisions in EU trade agreements and which will be included in future agreements.

Investment protection provisions, including investor-state dispute settlement are important for investment flows. They have generally worked well. However, the system needs **improvements**. These relate to finding a better balance between the **right of states to regulate** and the **need to protect investors**, as well as to making sure the arbitration system itself is above reproach e.g. transparency, arbitrator appointments and costs of the proceedings.

The Lisbon Treaty made negotiating investment agreements an EU competence. This will over time bring the obvious benefit of having a single set of investment protection rules for all 28 Member States in EU trade and investment agreements.

It also provides a unique opportunity to set a new agenda for investment protection and investor state dispute settlement provisions. This also reflects the views expressed by the European Parliament in its Resolution the future of European international investment policy adopted on 6 April 2011.

The EU can draw on lessons from how the arbitration system has worked so far in order to make changes to the system of investment protection. With its global economic weight, the EU is in a strong position to convince its trading partners of the need for clearer and better standards. The primary vehicle for this will be through **bilateral** negotiations. We also have the possibility to influence the **multilateral** context, for example through the United Nations Commission on International Trade Law (UNCITRAL) – where the EU has already successfully created new rules on transparency that will apply beyond the EU's own investment agreements.

1. Why is investment protection included in trade agreements?

Investment is a **critical factor for growth and jobs.** This is particularly the case in the EU, where our economy is very much based on being open to trade and investment. Investment is key in creating and maintaining businesses and jobs. Through investment, companies build the global value chains that play an increasing role in the modern international economy. They not only create new opportunities for trade but also **value-added, jobs and income.** That is the reason why trade agreements should promote investment and create new opportunities for companies to invest around the world.

Companies investing abroad do encounter problems which - for a variety of reasons - cannot always be solved through the domestic legal system. These problems range from the rare, but dramatic, occurrences of expropriations by the host country by force, discrimination, expropriation without proper compensation, revocation of business licences and abuses by the host state such as lack of due process to not being able to make international transfers of capital.

Precisely because of these risks, provisions to protect investments have been part and parcel of all the **1400 bilateral agreements entered into by EU Member States since the late 1960s**. The EU itself is party to the Energy Charter Treaty, which also contains provisions to protect investments and investor to state dispute settlement. Worldwide, there are over 3400 such bilateral or multiparty agreements in force containing provisions to protect investments. They provide **guarantees** to companies that their investments will be treated fairly and on an equal footing to national companies. By creating legal certainty and predictability for companies, investment protection is also **a tool for states around the world to attract <u>and maintain</u> FDI** to underpin their economy.

2. What do investment protection provisions provide for?

In concrete terms, virtually all such agreements provide foreign investors with **four key guarantees** in their relationship with the host state:

- ✓ Protection against **discrimination** (most-favoured nation treatment and national treatment);
- ✓ Protection against **expropriation which is not for a public policy purpose** and not fairly compensated;
- ✓ Protection against **unfair and inequitable treatment** – e.g. denying basic procedural fairness; and,
- ✓ Protection on the possibility to **transfer capital**.

Investment agreements also provide for **an “investor-state dispute settlement”** or “**ISDS**” system. This is regarded as a key element for effectively enforcing the protection provided. This system allows an investor to directly bring a claim against the authorities of the host country in front of an international tribunal. However, the investor can only bring a case where it can allege that **one of the provisions of the agreement (e.g. the four key guarantees above) has been breached**. <u>This means that an investor who</u>

brings a case because his profits have been reduced following a regulatory change by a state (e.g. stricter regulations on a food additive) cannot get compensated on this basis alone. The investor would need to demonstrate that the investment provisions have been breached (e.g. discrimination, denial of justice…).

The main reason for having an ISDS mechanism is because in many countries investment agreements are not directly enforceable in domestic courts. Therefore, an investor who finds him- or herself discriminated against or whose investment is expropriated cannot invoke investment protection rules before the domestic court to get redress. Investor-to-state dispute settlement allows investors to rely directly on the rules that were specifically designed to protect their investments.

EU investors have been amongst the biggest users of the dispute settlement procedures and account for a growing number of cases. According to recent UNCTAD figures, Of the 214 (known) ISDS cases registered worldwide for the period 2008-2012, **EU investors accounted for 53 % of the cases (113 cases)** with investors from the Netherlands, Germany and the United Kingdom as the main users. The sharp increase in EU investors' use of ISDS is even more noticeable in the figures for recent initiations. **Of the cases initiated in 2012 – a total of 52 -, EU investors were behind 60 % of all initiations, while US investors accounted only for 7.7%**.

3. The imperfections of the current system

While the number of cases brought to arbitration is small compared to the hundreds of thousands of investment decisions made daily benefiting both the host countries and companies investing in them, some of the most recent cases brought by investors against states have given rise to strong public concerns. The main concern is that the current investment protection rules may be abused to prevent countries from making legitimate policy choices.

Amongst the cases that have caught the public attention are the on-going cases Vattenfall vs. Germany and Philip Morris vs. Australia. The Swedish energy company Vattenfall has brought a claim against the German government (under the Energy Charter Treaty) after its decision in 2011 to significantly speed up the phase out of nuclear power generation. The US owned company Philip Morris has challenged the government of Australia for the latter's decision to ban brand names on cigarette packs (the 'plain packaging' measure) for reasons of public health.

These cases are not yet decided. The German Government and Vattenfall have not made public any documents related to their case. Some documents are available as regards the Philip Morris case. It is not possible to gauge whether either case will be successful. What is clear, however, is that neither Germany nor Australia have made any changes to their policies as a result of the cases brought by the investors nor can they be forced to do so by these tribunals.

The public concerns raised surrounding these cases are legitimate and need to be addressed. We want to ensure that tribunals interpret the rules in the way the parties had intended them. While some tribunals have interpreted the provisions to confirm the right of states to regulate for the public good (see Box 1), thereby releasing states from the obligation to compensate, other tribunals have not made this sufficiently clear.

Box 1: Extracts from ISDS Tribunal regarding the right of states to regulate

Saluka Investments B.V. vs. The Czech Republic (2006)
It is now established in international law that States are not liable to pay compensation to a foreign investor ***when, in the normal exercise of their regulatory powers, they adopt in a non-discriminatory manner bona fide regulations that are aimed at the general welfare****.*

Methanex vs. United States (2005)
As a matter of general international law, a non-discriminatory regulation for a public purpose, which is enacted in accordance with due process and, which affects, inter alia, a foreign investor or investment ***is not deemed expropriatory and compensable*** *unless specific commitments had been given by the regulating government to the then putative foreign investor contemplating investment that the government would refrain from such regulation.*

However, it is important to bear in mind that arbitrators in an investor to state procedure operate within a certain framework and have to apply the specific rules contained in an investment agreement. This means that decisions by arbitrators are only as good as the rules they are asked to apply. Vague rules will, by definition, leave room for interpretation.

So we need to ensure that:

(1) The rules in trade agreements for protecting investments are clearly defined and do not leave room for interpretative ambiguity. This is especially important where it concerns the state's right to regulate for public policy objectives; and

(2) Arbitrators work according to a clear set of procedures that ensures fair process and transparency.

Some key **investment protection provisions are unclear**. The way they are drafted has led to claims that such provisions do in fact undermine the ability of states to regulate in the public interest. For instance, many investment agreements in force do not specify the exact meaning and scope of key substantive standards such as 'indirect expropriation' or 'fair and equitable treatment' – precisely the issues under which investors bring the most claims.

The way **dispute settlement** is carried out also varies. Under the majority of existing Bilateral Investment Treaties, cases take place behind closed doors unless both parties agree otherwise. Also, some companies try their luck and attempt to file cases without merit. Such cases are normally eventually dismissed, but they take up time and money for the state concerned and may be seen as a way to put pressure on it not to take certain policy measures. Although most 'long shot' cases are rejected by arbitrators, they may nevertheless give the impression that the system poses a threat to the right to regulate.

4. What is the EU doing to improve investment protection rules?

The Commission's aim in to bring improvements on two fronts (1) to clarify and improve investment protection rules and (2) to improve how the dispute settlement system operates. Such improvements will address the concerns raised that investment protection rules may negatively impact states' right to regulate. They should, amongst other things, ensure that companies cannot successfully bring claims against states' regulatory policies when these are taken for public policy reasons.

1. **<u>Clarifying and improving investment protection rules</u>**

All of the EU's Free Trade agreements clearly confirm, as a standing principle, the Parties' **right to regulate and to pursue legitimate public policy objectives** such as social, environmental, security, public health and safety, and the promotion and protection of cultural diversity. This principle will apply to investment protection provisions included in EU agreements as well.

In addition, in EU trade agreements the key investment protection standards are drafted in a detailed and precise manner, **in particular making clear that the States' right to regulate is preserved**.

In this context clarifications to two key provisions are made:

- Firstly, '**indirect expropriation**' is one of the most controversial provisions in the investment protection system. Indirect expropriation is when government measures, while not directly taking property away, have the effect of doing so (e.g. the removal of a license required to operate a factory). This provision has been used by some investors to challenge public authorities' bans for health reasons of chemical products or the introduction of new stricter environmental legislation. Future EU agreements will provide a detailed set of

provisions giving guidance to arbitrators on how to decide whether or not a government measure constitutes indirect expropriation, thus aiming at preventing abuse of the system.
In particular, when the state is protecting the public interest in a non-discriminatory way, the right of the state to regulate should prevail over the economic impact of those measures on the investor. These much needed clarifications will make sure that **companies cannot be compensated just because their profits have been reduced** through the effects of regulations enacted for a public policy objective. The Commission has negotiated provisions with Canada and Singapore which makes this clear, and the language will also be included in future agreements.

- Secondly, the standard of '**fair and equitable treatment**' – very frequently invoked by investors – is not clearly defined in international law. As a result, tribunals have had significant leeway in interpreting this in a manner that has been seen as giving too many or too few rights to investors. In EU agreements, the standard will set out precisely which actions are not allowed. This will include issues such as manifest arbitrariness, abusive treatment (coercion, duress or harassment), or failure to respect the fundamental principles of due process. These elements of 'fair and equitable treatment' are precisely defined in the Canada and Singapore texts, and will also be defined in future EU treaties.

2. Improving how the dispute settlement system operates.

➢ Preventing investors from bringing multiple or frivolous claims

Firstly, the EU will prohibit two types of claims being brought at the same time before different tribunals. Avoiding parallel claims **will prevent investors potentially winning twice** and also avoid a situation where two different tribunals come to different decisions based on the same facts.

In order to discourage '**long shot'** and **frivolous claims** by investors, the EU has agreed provisions to enable tribunals to dismiss such claims quickly and also to require that all litigation costs are borne by the losing party. Under the existing system, in some cases, even if the state wins the case, it still has to pay its litigation costs which can be very substantial. If the investor has to pay the litigation costs for all parties if he loses the case, it may act to discourage “long shot” cases.

➢ Making the arbitration system more transparent

Firstly, the EU has successfully pushed for **more transparency** at international level. The EU has played a leading role in the negotiations in the United Nations Commission for International Trade Law (**UNCITRAL**) where countries have agreed rules on the transparency of international investment proceedings.

These rules ensure that the proceedings of international tribunals are transparent. The rules will make documents available to the public, provide access to hearings and allow interested parties (like environmental NGOs) to make submissions.

Secondly, the EU has already introduced these UNCITRAL transparency obligations in its agreement with Canada and will push for similar provisions in its other agreements.

- **<u>Dealing with conflicts of interests and consistency of arbitral awards</u>**

The EU has introduced a **code of conduct** that sets out specific and compulsory obligations for arbitrators. Such a code of conduct is already a reality in the negotiated agreement with Canada and the EU will push for this in future agreements on investment. These obligations will cover conflicts of interests as well as broader questions about the ethics of arbitrators i.e. how they should act in particular situations.

The EU has included in the trade agreement with Canada a list of individuals - to be agreed by both the EU and Canada - who can act as arbitrators in a particular dispute. These individuals will be selected on the basis of their expertise and must comply with the code of conduct. This will eliminate the risk of **vested interests**. It will push for similar lists with other negotiating partners. The EU is also, again a new element in the dispute settlement system, aiming for the creation of an **appellate mechanism** to ensure consistency and increase the legitimacy of the system by subjecting awards to review.

- **<u>Introducing safeguards for the Parties</u>**

The EU has in the agreement with Canada agreed clauses that allow countries that have signed an agreement to agree jointly on how they interpret the agreement. These clauses would allow the investor's home country to make submissions in on-going procedures. These are additional safeguards, permitting the Parties to influence interpretations and **correct any potential erroneous interpretations** by the tribunals as this will allow states to influence how the investment provisions are being interpreted.

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Facts and figures on ISDS

*based on statistics compiled by UNCTAD

I. Use of ISDS provisions

Of all 514 (known) ISDS cases (decided and pending):

- 24 % brought by US investors (124 cases).
- 26 % brought by EU investors (at least 132 cases)
  - NL: 50
  - UK: 30
  - DE : 27
  - FR: 7
  - Other EU MS: 18

Figures **for the last five years** (2008-2012), indicate a sharp increase in cases brought by EU investors. Of the 214 (known) ISDS cases registered worldwide for this period, EU investors accounted for 52 % of the cases (113 cases). Of these 113 cases, 27 % were intra-EU cases (based on BITs: 19) and based on Energy Charter Treaty cases (12).

The increase in EU investors' use of ISDS is noticeable in the figures for recent initiations. Of the 52 new cases **initiated in 2012** (thus no decision reached yet):

- EU investors: 60 % of all initiations (31)
- US investors: 7.7 % (4)
- Russia: 5.8 % (3)
- Canada: 3.8 % (2)
- Other (Australia, Egypt, Barbados, China, Turkey): 22.7 % (12)

Most used ISDS instruments

- NAFTA: 66 cases (19 against USA, 28 against Canada, 19 against Mexico) (until end 2010)
- Energy Charter Treaty: 37 cases (until end 2013)
- Argentina-US BIT: 17 cases (until end 2012):
- BITs with Argentina, Venezuela, Ecuador: 109 cases (until end 2012)

Under the Energy Charter Treaty dispute settlement provisions, EU investors have launched the most cases, accounting for almost 80 % of all cases i.e. 29 cases out of a total of 37 cases brought in the period 2001-2013: UK: 5, NL: 5, Cyprus: 5, Sweden: 3, Poland: 2, Austria: 2, Italy: 1, Croatia: 1, France: 1, Belgium: 1, Greece: 1, Latvia: 1, Czech Republic: 1