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By Christiane Gerstetter and Nils Meyer-Ohlendorf

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Ecologic Institute, Berlin
Contact: christiane.gerstetter@ecologic.eu

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# Executive Summary

The Transatlantic Trade and Investment Partnership (TTIP) could include rules on investment protection, including so called investor- state dispute settlement (ISDS). ISDS is a system that allows private investors to sue a host state for the alleged violation of an international investment treaty concluded between that host state and the investor's country of origin. The EU Commission's negotiating mandate for TTIP and the US model bilateral investment treaty both indicate a preference for including ISDS in TTIP.

There are a number of clauses routinely contained in investment treaties that have the potential to restrict the right of governments to take environmental measures: the requirement of "fair and equal treatment" for investors, a prohibition on "(indirect) expropriation", and the so-called umbrella clause. All of them are often broad and vague in wording, and; the case law interpreting them is not consistent.

Although investment tribunals never invalidate environmental regulations, nor have any similar direct impact on national environmental policies, they have – in some cases – awarded considerable compensatory payments to investors for a violation of the above clauses. The inclusion of any of these norms in TTIP would not automatically prevent the US or the EU adopting environmental measures in the future, nor would they necessarily have to pay compensation to investors whenever doing so. However, the results of ISDS proceedings are unpredictable. Some arbitration tribunals have taken a restrictive approach to governments' regulatory freedom; others have deemed government regulation not to violate investment law. These uncertainties result in considerable risks for environmental regulation which are exacerbated by the fact that investment-related provisions tend to be interpreted broadly in ISDS proceedings.

There are no strong arguments for including ISDS rules in TTIP. Both the US and the EU have highly evolved, efficient rule of law legal systems. There is no evidence that investors have ever lacked appropriate legal protection through these systems. There is no bilateral investment treaty between the US and any of the old EU Member States, and yet US and EU investors already make up for more than half of foreign direct investment in each others' economies. This demonstrates that investors seem to be satisfied with the rule of law on both sides of the Atlantic.

ISDS provides foreign investors with an additional judicial remedy that is not available to domestic competitors; this additional avenue of legal redress discriminates against domestic companies and has the potential to distort competition. Furthermore, the sheer size of foreign direct investment could lead to a considerable number of investment disputes. As a consequence, large numbers of disputes that normally would be adjudicated in domestic courts would be subject to international arbitration, bypassing domestic judges that have been elected or appointed by elected officials.

However, in the event that provisions on ISDS are nonetheless included in TTIP, this paper provides suggestions on how to formulate such provisions in order to mitigate the risk to environmental regulations.

# 1 Introduction

The Transatlantic Trade and Investment Partnership (TTIP) could include rules on investment protection, including so called investor-state dispute settlement (ISDS). ISDS is a mechanism allowing private companies to sue a host state for the alleged violation of an investment treaty concluded between that host state and the investor's country of origin. Typically, investors seek monetary compensation for alleged economic damages resulting from the behavior of the host state. The impugned behavior of a host state could consist of a range of measures, such as revoking or not granting a permit, adopting regulations resulting in reduced profits, cancellation of a contract, or changes in tax laws. An investor's claim is successful if the defending state party has violated the investment treaty.

ISDS rules are mentioned in the **EU Commission's negotiating mandate** as one of the aspects that the EU intends to include in TTIP.[1] The US 2012 model Bilateral Investment Treaty (BIT),[2] a blueprint for US investment negotiations, also contains extensive rules on investment protection and ISDS, suggesting a similarly positive stance towards ISDS. The 2012 joint EU/US statement on Shared Principles for International Investment also calls for ISDS; according to the statement, ISDS procedures should be open and transparent, with opportunities for public participation.[3] In January 2014, however, the European Commission announced it would hold public consultations on the proposed EU text of TTIP's investment chapters, including sections on investment protection and on ISDS.[4]

Investment protection in TTIP and ISDS as an enforcement mechanism are very controversial. Representatives of the **business sector** support such provisions; among ISDS supporters are companies involved in environmentally sensitive activities. For example, the US energy company Chevron called for strong rules on investment, including ISDS.[5]

**Civil society**[6] representatives have, in contrast, voiced serious concerns about ISDS provisions and the way they could negatively impact environmental, social, health, labor, or other regulation within the US or the EU. NGOs are concerned that environmental regulation or decisions taken for environmental reasons (e.g. revoking a permit for a polluting facility) may be considered a violation of an investment treaty (e.g. prohibition of expropriation) in ISDS proceedings.

Against this backdrop, this paper discusses the potential impact of rules of investment protection and ISDS in TTIP on existing environmental regulation and the US and EU's future regulatory freedom in this area. While the focus here is on environmental regulation, much of what is discussed below is also applicable to measures taken for other public policy purposes – e.g. health and consumer protection, or workers' rights.

The paper is structured as follows: In section 2 we provide a brief background on ISDS in general. Section 3 describes the case law clauses often contained in investment treaties that are also mentioned in the EU's negotiating mandate for TTIP. The aim is to assess the extent to which fears of a negative impact of TTIP's potential ISDS rules having a negative impact on environmental regulation are justified. This section also discusses whether recent suggestions by the EU Commission of how investment-related rules should be phrased could mitigate potential risks from ISDS. In section 4 we present the positions of government actors, the business sector, and civil society regarding the inclusion of ISDS in TTIP. Section 5 presents our own conclusions and policy recommendations.

1 The leaked mandate is available at http://www.s2bnetwork.org/fileadmin/dateien/downloads/EU-TTIP-Mandate-from-bfmtv-June17-2013.pdf
2 Available online at http://www.state.gov/e/eb/ifd/bit/index.htm
3 The text is online at http://trade.ec.europa.eu/doclib/press/index.cfm?id=796
4 European Commission, DG Trade, *Commission to consult European public on provisions in EU-US trade deal on investment and investor-state dispute settlement*, Press release 21 January 2014, http://trade.ec.europa.eu/doclib/press/index.cfm?id=1015
5 Chevron Corporation, *Comments on Proposed Transatlantic Trade and Investment Partnership*, May 7, 2013, http://www.regulations.gov/contentStreamer?objectId=09000064812d4166&disposition=attachment&contentType=pdf
6 We use the terms "civil society" or "non-governmental organizations (NGOs)" to refer to not-for-profit, public interest groups. With these terms, we do not refer to companies or their associations.

# 2 Background

ISDS grants private companies or citizens the right to sue a host state for the alleged violation of an investment treaty – often without requiring investors to seek legal redress through national courts first. This makes ISDS a **unique instrument** in international law. In other areas of international law, there are, generally speaking, no avenues for private actors to hold foreign states accountable for treaty violations. Neither international human rights law nor international environmental law, for example, give individuals or corporations such privileges.

Rules allowing investors to bring claims directly against a state **are included in most of the about 3 000 international investment agreements**[7] (IIAs).[8] Many of these investment treaties have been concluded between a developed country on the one side and a developing country on the other. TTIP would be an unusual case, as it would be concluded between developed countries, each with a well-developed legal system.

There are, however, several bilateral investment treaties (BITs) between new EU Member States and the US, all of which contain rules on ISDS:

- BIT between Bulgaria and the US (1994, Art. VI[9]
- BIT between Croatia and the US (2001, Art. X)[10]
- BIT between the Czech Republic/Slovakia and the US (1992,[11] Art. VI)[12]
- BIT between Estonia and the US (1997, Art. VI)[13]
- BIT between Latvia and the US (1997, Art. VI)[14]
- BIT between Lithuania and the US (2001, Art. VI)[15]
- BIT between Poland and the US (1994, Art. IX)[16]
- BIT between Romania and the US (1994, Art. VI)[17]

None of the "old" EU Member States have a BIT with the US. The EU itself has not yet concluded any BITs, as it has only has a competence for investment matters since the Lisbon Treaty entered into force in 2009.[18]

The **number of investor-state investment dispute**s has sharply risen in recent years. For example, in 2012, 52 new investment disputes were filed, the "highest number of known treaty-based disputes ever filed in a single year."[19] Through the end of 2012, there have been altogether 514 known disputes, about half of them having already been resolved. Of these, about 40% were decided in favor of the state and approximately 30% in favor of the investor. The remainder was settled amicably.[20] EU investors accounted for more

7 International investment agreements can be bilateral in nature or involve more parties. Investment-related clauses can also be included in broader agreements, notably free trade agreements. Examples of international agreements with more than two parties and containing investment-related provisions include the North American Free Trade Agreement (NAFTA), the Central American Free Trade Agreement (CAFTA), and the ASEAN Comprehensive Investment Agreement.

8 David Gaukrodger and Kathryn Gordon, *Investor – State Dispute Settlement: A Scoping Paper for the Investment Policy Community,* OECD Working Papers on International Investment (Paris: OECD, 2012), 10, http://www.oecd.org/daf/inv/investment-policy/WP-2012_3.pdf present the results of a survey of more than 1 600 investment treaties and conclude that more than 90% of them provide for investor-state dispute settlement. In some of them, ISDS only relates to disputes over expropriation, see Pohl, Joachim, Kekeletso Mashigo, and Alexis Nohen. *Dispute Settlement Provisions in International Investment Agreements: A Large Sample Survey*. OECD Working Papers on International Investment. Paris: OECD, 2012, 10, http://www.oecd.org/daf/inv/investment-policy/WP-2012_2.pdf

9 Available online at http://tcc.export.gov/Trade_Agreements/All_Trade_Agreements/exp_002792.asp

10 Available online at http://tcc.export.gov/Trade_Agreements/All_Trade_Agreements/exp_002634.asp

11 Years refer to the entry into force.

12 Available online at http://tcc.export.gov/Trade_Agreements/All_Trade_Agreements/exp_002809.asp

13 Available online at http://tcc.export.gov/Trade_Agreements/All_Trade_Agreements/exp_002814.asp

14 Available online at http://tcc.export.gov/Trade_Agreements/All_Trade_Agreements/exp_005848.asp

15 Available online at http://tcc.export.gov/Trade_Agreements/Exporters_Guides/List_All_Guides/TOA_LithuaniaBIT.asp

16 Available online http://tcc.export.gov/Trade_Agreements/All_Trade_Agreements/exp_005367.asp

17 Online at http://tcc.export.gov/Trade_Agreements/All_Trade_Agreements/exp_005370.asp

18 An exclusive competence for the EU on investment is now contained in Art. 207(2) of the Functioning of the European Union (TFEU). The future legal status of BITs concluded by the Member States is regulated by Regulation (EU) No 1219/2012 of the European Parliament and of the Council of 12 December 2012 establishing transitional arrangements for bilateral investment agreements between Member States and third countries, *OJ L 351, 20.12.2012, p. 40-46.*

19 UNCTAD, *Recent Developments in Investor-State Dispute Settlement (ISDS)*, IIA Issues Note (Geneva: UNCTAD, 2013), 1, http://unctad.org/en/PublicationsLibrary/webdiaepcb2013d3_en.pdf

20 Ibid.

than half of the 214 known ISDS cases registered worldwide for the period 2008-2012.[21]

ISDS is an **additional avenue of dispute resolution** for investors. Domestic and foreign investors have access to domestic courts according to national law and may request domestic courts to review the legality of state measures affecting their investment.[22] IIAs typically allow investors to file claims with international arbitration tribunals without initiating proceedings before a national court first – the exhaustion of domestic remedies is only a requirement in a small proportion of the investment treaties currently in force.[23] By contrast, norms in other fields of international law, such as international human rights law, require the exhaustion of domestic remedies before a case may be brought before an international body.

**Procedural norms** regarding ISDS in investment treaties differ in various details, but contain a number of common features:

- IIAs normally determine which **forum** investors may use for dispute settlement. The World Bank's International Center for the Settlement of Investment Disputes (ICSID) is the most frequently chosen forum.[24] IIAs often require attempts to amicably settle the dispute before international arbitration may be initiated.[25] Under ICSID procedures, disputes are decided by a group of three **arbitrators**; these are agreed upon by the parties to the dispute, i.e. an investor as claimant and a state as defendant, or appointed by ICSID bodies in case the parties do not agree.[26] Arbitrators are normally lawyers specialized in international investment law. Overall, there are relatively few individuals serving as investment arbitrators and a very small number of them deciding on a high number of disputes.[27] Many of the arbitrators serve as legal counsel to parties, predominantly investors, in other cases.[28] The fact that a relatively small number of legal professionals are involved in such cases in changing roles (arbitrators/legal counsel) means that they have considerable expertise on the matter. It also means, however, that arbitrators are not necessarily neutral, disinterested third parties – if arbitrators are likely to represent an investor in a future case, they are likely to interpret the law accordingly – there are conflict of interests.

- Proceedings and documents are normally **not public** unless parties to the dispute agree on publishing them or if this is stipulated in the investment treaty itself. However, only a very small percentage of IIAs contain provisions on public access to proceedings and results.[29] The confidential nature of investment disputes is exceptional in international law. In other cases where individuals seek recourse at the international level against state behavior, such as in the international human rights system or the WTO dispute settlement mechanism, rulings are public.

- While investors are free to seek whatever form of redress they consider appropriate, a specific feature of investment disputes is that investors normally seek **monetary compensation** for state behavior.[30] This differs from national judicial proceedings, where monetary compensation is – depending on the respective legal order – the exception rather than the norm. Instead, in national court procedures, if a measure (e.g. a decision to revoke an operating license for an industrial facility) is considered illegal, courts will more often simply invalidate the controversial measure.

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21 EU Commission, Fact sheet: Investment Protection and Investor-to-State Dispute Settlement in EU agreements, November 2013, 5 http://trade.ec.europa.eu/doclib/docs/2013/november/tradoc_151916.pdf

22 According to Joachim Pohl, Kekeletso Mashigo, and Alexis Nohen, *Dispute Settlement Provisions in International Investment Agreements: A Large Sample Survey*, OECD Working Papers on International Investment (Paris: OECD, 2012), 11, http://www.oecd.org/daf/inv/investment-policy/WP-2012_2.pdf, over 70% of recent investment treaties explicitly mention domestic judicial review as a dispute settlement mechanism.

23 In their review of ca. 1600 BITs, Pohl, Mashigo, and Nohen, Dispute *Settlement Provisions in International Investment Agreements: A Large Sample Survey* find only 8% contain a requirement that an investor must resort to the domestic court system before initiating an ISDS procedure.

24 Other important mechanisms include ad hoc tribunals under UNCITRAL rules or the International Chamber of Commerce.

25 Pohl, Mashigo, and Nohen, *Dispute Settlement Provisions in International Investment Agreements: A Large Sample Survey,* 17.

26 See Rule 3 of the ICSID Rules for Arbitration Proceedings, available online at https://icsid.worldbank.org/ICSID/StaticFiles/basicdoc/CRR_English-final.pdf

27 Gaukrodger and Gordon, *Investor – State Dispute Settlement: A Scoping Paper for the Investment Policy Community*, 45 refer to a study showing that only 12 arbitrators have been involved (typically as one or more of three arbitrators) in 60% of a large sample of ICSID cases (a total of 158 cases out of 263 tribunals).

28 Ibid., 44 note that more than 50% of ISDS arbitrators seem to have acted as counsel fo investors in other cases, while only 10% of them have done so for states.

29 Pohl, Mashigo, and Nohen, *Dispute Settlement Provisions in International Investment Agreements: A Large Sample Survey*, 36.

30 Gaukrodger and Gordon, Investor – *State Dispute Settlement: A Scoping Paper for the Investment Policy Community*, 11, 26.

– **Damages awarded** in international investment cases can be very high – the highest known damage awarded in an ICSID case was US$1.77 billion to the US oil company Occidental Petroleum in a case against Ecuador.[31] Investor-state disputes can also lead to significant legal costs for the defending state: legal costs in investor-state disputes average over US$8 million per case and in some cases exceed US$30 million.[32] The legal costs are not always awarded to the winning party, i.e. a state may have to pay millions of dollars, even if it has won the case.[33] Legal costs and compensation are paid from public budgets.

– Another characteristic of ISDS proceedings is that **awards are usually final**.[34] Mechanisms for a full legal review of the awards do not exist; redress mechanisms are limited. Under ICSID procedures, only an internal ICSID review is possible[35] – the conditions under which ICSID may revise or annul a previous award are, however, extremely restricted.[36] In other settings, it is possible in principle to submit an award to a national court for review.[37] However, the grounds on which an award can be modified by the national court are also limited.[38] The absence of an appellate stage is not uncommon in international courts, but there are also a number of judicial institutions at the international level that have an appellate mechanism in place. The WTO is a well-known example. In the case of ISDS, the absence of such a review mechanism appears all the more problematic as the procedures are generally not public and there is at least a potential for a built-in, pro-investor bias, resulting from the same lawyers acting as arbitrators and counsels for investors in different cases. The absence of an investment-related appellate body is also one the factors for the lack of consistency in interpretation in the case law (see next section).

31 Tai-Heng Cheng, ICSID's Largest Award in History: An Overview of Occidental Petroleum Corporation v the Republic of Ecuador, 19 December 2012, http://kluwerarbitrationblog.com/blog/2012/12/19/icsids-largest-award-in-history-an-overview-of-occidental-petroleum-corporation-v-the-republic-of-ecuador/. The case only had an indirect environmental component, as it concerned the seizure of oil drilling equipment.

32 Gaukrodger and Gordon, *Investor – State Dispute Settlement: A Scoping Paper for the Investment Policy Community,* 19.

33 ICSID rules give arbitrators discretion on allocating costs; by contrast, UNCTIRAL rules state that by default the losing party has to pay, see Pohl, Mashigo, and Nohen, *Dispute Settlement Provisions in International Investment Agreements: A Large Sample Survey,* 35.

34 However, as Katia Yannaca-Small, ed., *Arbitration Under International Investment Agreements: A Guide to the Key Issues* (Oxford University Press, 2010), 635 observes, enforcement of awards can be quite a lengthy process.

35 See Art. 53 ICSID Convention.

36 For example, Art. 52 ICSID Convention states that an annulment is only possible if the Tribunal was not properly constituted or has manifestly exceeded its powers, there was corruption on the part of a member of the Tribunal, there has been a serious departure from a fundamental rule of procedure, or the award has failed to state the reasons on which it is based.

37 E.g. under the investment chapter of the North American Free Trade Agreement (NAFTA), the Energy Charter Treaty or UNCITRAL rules.

38 Kai Hobér and Nils Eliasson, "Review of Investment Treaty Awards by Municipal Courts," in *Arbitration Under International Investment Agreements: A Guide to the Key Issues*, ed. Katia Yannaca-Small (Oxford University Press, 2010), 639 observe that many countries have adopted the UNICTRAL Model Law on International Commercial Arbitration with regard to reviews of investment awards by national courts. Under the UNICTRAL Model Law, national courts may essentially review whether some fundamental mistakes were made, e.g. the arbitrators were not competent to decide on the matter or the tribunal was constituted in an unlawful manner.

# 3 ISDS and environmental regulation – past experiences

Environmental issues have been the subject of numerous ISDS cases. Germany, for example, was or is the defendant in two recent cases, each filed by Vattenfall, a Swedish energy company, under the Energy Charter Treaty.[39] Vattenfall challenged two energy-related decisions: certain environment-related conditions contained in the permit for a power plant in Hamburg and the closure of two nuclear power plants. Other examples include cases dealing with waste management in Mexico and California's mining policy.

Although different in many aspects, they focus on a limited number of clauses routinely contained in investment treaties:

- the requirement of "fair and equitable treatment" (FET) for investors;
- a prohibition on "(indirect) expropriation";
- and the so-called umbrella clause.

The **EU's negotiating mandate for TTIP relates to all of these rules as elements of the TTIP negotiations**. For this reason, this chapter discusses how these provisions have been interpreted in investment-related case law and how this case law could impact on environmental regulation (section 3.1). The EU's negotiating mandate also mentions a few other rules relating to investment (e.g. on non-discrimination); however, they appear to be less problematic in terms of a potential detrimental impact on parties' right to regulate and will therefore not be investigated any further here.

The Commission's negotiating mandate also stresses that rules on investment protection should be without prejudice to the right of the EU and the Member States to adopt and enforce measures "necessary to pursue legitimate public policy objectives such as social, environmental, security, stability of the financial system, public health and safety in a non-discriminatory manner"; this is resonant of typical exception norms in favor of such policy objectives as environmental or health protection. Moreover, in November 2013, the EU Commission indicated that future IIAs should give arbitrators detailed guidance on how to interpret "indirect expropriation" and "fair and equitable treatment."[40] Against this background, the chapter discusses, in a second step, treaty provisions and modifications that could reduce risks to environmental regulation (section 3.2).

### Box 1: Vattenfall vs. Germany I and II:

In recent years, Vattenfall, a Swedish power utility, has initiated two arbitrations against Germany. The first case, concerning a power plant in Hamburg-Moorburg, is settled. The second case, regarding the closure of two nuclear power plants, is still pending.

**Vattenfall vs. Germany (Moorburg):** In 2009, Vattenfall filed a complaint against the German federal government with the ICSID. The subject was the licensing of new coal-fired power plant in Hamburg-Moorburg. According to Vattenfall, the required water license would make the investment "unviable," violating Art. 3 of the Energy Charter Treaty. Vattenfall reportedly filed a claim against Germany for about **€1.4 billion,** plus arbitration costs and interest. The dispute between Germany and Vattenfall was settled in the spring of 2011, after Germany had agreed to a less stringent license.[41]

**Vattenfall Nuclear Phase Out:** Following the Fukushima disaster in March 2011, Germany decided to phase out its use of nuclear power plants by 2022. Germany also ordered the immediate closure of 7 nuclear power plants, including the power plants in Krümmel and Brunsbüttel, both operated by Vattenfall. In response to this closure, Vattenfall filed for arbitration under the Energy Charter

39 The Energy Charter Treaty is a legally binding international treaty, which entered into force in 1998. The treaty covers aspects of commercial energy activities such as trade, transit, investments, and energy efficiency.

40 European Commission, Fact sheet: Investment Protection and Investor to State Dispute Settlement in EU agreements, November 2013, http://trade.ec.europa.eu/doclib/docs/2013/november/tradoc_151916.pdf

41 Nathalie Bernasconi-Osterwalde and Rhea Tamara Hoffman, *Der deutsche Atomausstieg auf dem Prüfstand eines internationalen Investitionsschiedsgerichts? Hintergründe zum neuen Streitfall Vattenfall gegen Deutschland (II)* (Geneva/Frankfurt/Berlin: Power Shift/Forum Umwelt und Entwicklung, March 2012), http://www.iisd.org/pdf/2012/powershift_forum_briefing_vattenfall.pdf

Treaty. Vattenfall is reportedly requesting **€3.7 billion** in compensation.[42] The case is still pending. Its exact content is not public, but it is likely that Vattenfall claims a violation of Article 10 of the Energy Charter Treaty. Article 10(1) commits Parties "to accord at all times to Investments of Investors of other Contracting Parties fair and equitable treatment." In addition, Vattenfall might argue that the closure of its two power plants amounts to an "indirect expropriation" or a "measure having an effect equivalent to nationalization or expropriation" (Article 13 of the Energy Charter Treaty).

## 3.1 Case law on investment norms and its implication for environmental regulation

Investment case law is not a consistent, uniform body of law. UNCTAD observes that there have been "divergent legal interpretations of identical or similar treaty provisions as well as differences in the assessment of the merits of cases involving the same facts."[43] Consequently, there is considerable uncertainty of how an arbitration panel would interpret an investment norm in a given case. To illustrate the degree of uncertainty, this subsection presents a few leading cases which interpreted clauses requiring the "fair and equitable treatment" (FET) of investors, (indirect) expropriation, and umbrella clauses.

### 3.1.1 Fair and equitable treatment

The requirement of according investors "fair and equitable treatment" (FET) is not only commonly included in treaties, but also very relevant, practically speaking. For example, in 74% of the cases won by US investors, tribunals found an FET violation.[44] It is the most frequently invoked standard in investment disputes.[45]

FET clauses have been **interpreted in many different ways**. Interpretations vary for a number of reasons. First, the wording of FET clauses might be similar, but differ in (crucial) details. Second, the FET requirement itself is broad and open to interpretation. In line with established legal methodology, the interpretation of an international legal norm depends on the wording of a particular treaty, but its context, objective, negotiating history, or other indications of the parties' intent are also to be taken into account.[46] Typically, the intention of parties to an investment agreement is to offer the best protection to the investor, allowing the free flow of investments into their territory.[47] By contrast, investment treaties do not typically mention environmental protection as an objective. Tribunals are likely to give higher priority to objectives mentioned explicitly in the treaty.[48]

In many cases, judicial decision-makers have been hesitant to offer an abstract definition of the term, but have rather resorted to defining certain types of behavior that constitute a violation of the FET clause:[49]

- **Arbitrariness and discrimination:** The case law indicates that fair and equitable treatment requires governments to act transparently and in good faith, refrain from arbitrary or discriminatory treatment and refrain from coercion.[50]

- **Access to justice:** A violation of FET occurs if a state denies access to justice, contrary to the principle of due process.

- **Legitimate expectations:** The principal objective of many investment treaties is "to maintain a stable framework for investments and maximum effective use of economic

42 Ibid.
43 UNCTAD, *Reform of Investor-State Dispute Settlement: In Search of a Roadmap,* IIA Issues Note (Geneva: UNCTAD, June 2013), 3, http://unctad.org/en/PublicationsLibrary/webdiaepcb2013d4_en.pdf
44 Corporate Europe Observatory and Transnational Institute, *A Transatlantic Corporate Bill of Rights – Investor Privileges in EU-US Trade Deal Threaten Public Interest and Democracy,* June 2013, 7, http://corporateeurope.org/sites/default/files/publications/corporate-bill-of-rights.pdf
45 Moshe Hirsch, "Between Fair and Equitable Treatment and Stabilization Clause: Stable Legal Environment and Regulatory Change in International Investment Law," *Journal of World Investment & Trade* 12 (2011): 789.
46 OECD, "*Indirect Expropriation*" and the "*Right to Regulate*" in *International Investment Law* (Paris, September 2004), http://www.oecd.org/daf/inv/investment-policy/33776546.pdf; relevant methods of interpretation in international law are set forth in Art. 31 of the Vienna Convention on the Law of Treaties.
47 Marcela Klein Bronfman, "Fair and Equitable Treatment: An Evolving Standard," *Max Planck Yearbook of United Nations Law* 10 (2006): 678, www.mpil.de/files/pdf3/15_marcela_iii1.pdf
48 Ole Kristian Fauchald, "International Investment Law and Environmental Protection," in *Yearbook of International Environmental Law*, ed. David Hunter and Ole Kristian Fauchald (Oxford University Press, 2008), 34.
49 Hirsch, "Between Fair and Equitable Treatment and Stabilization Clause," 789.
50 Ibid., 789f.

resources."[51] For this reason, a stable legal and business environment is considered an essential element of fair and equitable treatment.[52] A lack of respect for legitimate expectations of investors can constitute a violation of the FET principle. From an environmental point of view, this becomes problematic when an investor claims that an environmental measure is contrary to its legitimate expectations.[53]

A **number of cases** demonstrate a potentially harmful impact of investment arbitration over FET clauses on environmental policy making.[54] Examples include Tecmed v. Mexico and Metalclad Corp. vs. Mexico.[55] Other cases, such as Parkerings–Compagniet AS v. Republic of Lithuania,[56] however, show that FET requirements as interpreted in ISDS do not necessarily imply negative consequences for the environment:

- **Tecmed v. Mexico:** In Tecmed v. Mexico, the defendant, Mexico, refused to renew an operating permit for a landfill site. The claimant, a Spanish company, argued that the refusal constituted an expropriation of its investment without compensation and frustrated its justified expectations of the continuation of its investment. Mexico responded that the landfill had been operated in violation of specific environmental regulations, such as relevant limit values. The tribunal found that Mexico had violated the BIT between Mexico and Spain. More specifically, the tribunal stated: "*The foreign investor expects the host State to act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor, so that it may know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives, to be able to plan its investment and comply with such regulations*".[57] This particularly investor-friendly reading of the FET requirement has potentially far-reaching consequences for environmental policy making because it basically protects investor expectation from any changes to the regulatory environment. In light of this reading of the FET, any new or unknown regulation might constitute a violation of the FET requirement.[58]

- **Metalclad Corp. vs. Mexico:** Metalclad Corp, the Canadian claimant, had sought a building permit for a hazardous waste landfill in the Mexican State of San Luis Potosí. After a long series of contradictory events and discussions between federal and regional government authorities, the building permit was denied, while the landfill had already been built. In addition, the state governor declared the landfill's site a nature reserve in 1997, about two years after the landfill facility had been completed. Metalclad filed for arbitration under the North American Free Trade Agreement (NAFTA). It argued that the denial of the building permit and the declaration of the nature reserve constituted a violation of the FET clause and an indirect expropriation. The tribunal upheld these claims and awarded US$16.5 million to the claimant. Mexico, however, filed for a review before a court in Canada, where the claims regarding the building permit were annulled.[59]

- In the case of **Glamis Gold vs USA**, the tribunal stated that a state has to respect expectations that it had created to induce the investment; however, it required a shocking or egregious act for a violation of such expectations.[60]

- **Parkerings–Compagniet AS v. Republic of Lithuania:** The city of Vilnius and a subsidiary of the Norwegian claimant, had signed an agreement that required the claimant to build and operate a parking system in Vilnius. In return, the claimant was entitled to collect parking fees and penalties. Following a number of changes in national legislation and court cases, the city terminated the contract. The claimant requested arbitration with ISCID, stating, among other, that Lithuania had violated the FET clause, as contained in the BIT between Lithuania and Norway. The tribunal rejected

51 See: Preamble of the US-Argentina investment treaty, online at http://unctad.org/sections/dite/iia/docs/bits/argentina_us.pdf
52 CMS Gas Transmission Co. v. Republic of Argentina.
53 Fauchald, "International Investment Law and Environmental Protection," 18.
54 For an excellent overview of a number of ISDS proceedings relevant to sustainable development, refer to: Nathalie Bernasconi-Osterwalde and Lise Johnson, eds., *International Investment Law and Sustainable Development, Key Cases from 2000–2010* (IISD, n.d.), 75, http://www.iisd.org/pdf/2011/int_investment_law_and_sd_key_cases_2010.pdf
55 Tecnicas Medioambientales Tecmed S.A. v. United Mexican States, ICSID Case No. ARB(AF)/00/2 (Tecmed v. Mexico), Metalclad Corp. v. United Mexican States, ICSID Case No. ARB(AF)/97/1(Metalclad v. Mexico).
56 Parkerings–Compagniet AS v.Republic of Lithuania, ICSID Case No. ARB/05/8 (Parkerings v. Lithuania) http://ita.law.uvic.ca/documents/Pakerings.pdf
57 Tecnicas Medioambientales Tecmed S.A. v. United Mexican States, ICSID Case No. ARB(AF)/00/2 (Tecmed v. Mexico), para. 114.
58 Nathalie Bernasconi-Osterwalde and Lise Johnson, eds., *International Investment Law and Sustainable Development, Key Cases from 2000-2010* (IISD, n.d.), 75, http://www.iisd.org/pdf/2011/int_investment_law_and_sd_key_cases_2010.pdf
59 Nathalie Bernasconi-Osterwalde and Lise Johnson, eds., I*nternational Investment Law and Sustainable Development, Key Cases from 2000-2010* (IISD, n.d.), 75, http://www.iisd.org/pdf/2011/int_investment_law_and_sd_key_cases_2010.pdf
60 Ibid., 62.

the claim. It argued that investors should expect legislative and regulatory changes to affect their investments, and must exercise due diligence and structure those investments to ensure that they can "adapt…to the potential changes of the legal environment".[61] The BIT forbids a state only to act unfairly, unreasonably or inequitably in the exercise of its legislative power.[62] While this is not as such an environment-related case, it is of significance for cases where environmental regulation changes and investors need to comply with these changes.

In sum, **tribunals have applied different interpretations of the concept**.[63] Legal commentators have observed, however, that host states' regulatory measures alone are not generally considered sufficient for forming legitimate expectations and thus are not a violation of FET clauses in the case law. Rather, additional elements – specific contractual arrangements or promissory statements by the state – are needed to create such expectations.[64]

The **ambiguous case law makes reliable assumptions about the application of the FET clause and the outcome of an ISDS case difficult.**[65] It is difficult to predict the overall impact of FET clauses on environmental policy making. The vagueness of the FET clause combined with a tendency towards broad interpretation of investment protection clauses in ISDS creates largely unpredictable risks for national regulation and policies designed to protect the environment.

### 3.1.2 Expropriation

Expropriation is another **standard clause in investment treaties**. Expropriation clauses are also a practically relevant: expropriation has been centre stage of many ISDS disputes.

In international investment law, **expropriation is defined** as the formal withdrawal of property rights for the benefit of the State[65] or for private persons designated by the State. An example would be expropriating a landowner for the construction of public infrastructure, such as a road. This formal withdrawal of property is defined as "direct expropriation or formal expropriation. Direct expropriation has long been recognized and regulated in national legislation.

Next to direct expropriation, the vast majority of investment treaties also provide for protection against what is called **indirect expropriation or a "measure tantamount to expropriation"**.[66] There are various definitions of the term "indirect expropriation". Various treaties have it to mean "expropriation or any other equivalent measure having an effect similar," "having the same character or the same effect," or "having a similar effect" to dispossession. A few investment treaties, such as the US and Canadian model BITs contain explanatory annexes more specifically defining the expropriation clause.

From the viewpoint of environmental regulation, clauses on "indirect expropriation" are riskier than those on direct expropriation – given the breadth and vagueness of the terms above, many government measures having a negative economic effect could come within the purview of this clause.

Case law has developed the following criteria to define indirect expropriation:

- **Effect, magnitude, and nature of the measure:** The economic effect of a measure on the investment has been a central criterion for determining indirect expropriation (so called sole-effects doctrine). In the Tippets v. Iran award, the arbitrators explicitly rejected all other conceivable criteria: "[T]he government's intention is less important than the effects of the measures on the owner of the assets […], and the form of the measures of control or interference is less important than the reality of their impact." In addition, however, tribunals have required that the damage must be substantial; minor restrictions, simple administrative inconveniences, or other interferences do not result in indirect expropriation.

61 Parkerings–Compagniet AS v.Republic of Lithuania, ICSID Case No. ARB/05/8 (Parkerings v. Lithuania) http://ita.law.uvic.ca/documents/Pakerings.pdf (para. 333).
62 Ibid., paras. 332, 337.
63 Hirsch, "Between Fair and Equitable Treatment and Stabilization Clause," 790 with many references to case law.
64 Ibid. with many references to case law.
65 Suzy H. Nikièma, Best Practices Indirect Expropriation (IISD, 2012), http://www.iisd.org/publications/pub.aspx?pno=1577
66 Ibid.

– **Proportionality:** In various cases, tribunals have referred to the principle of proportionality to determine whether an indirect expropriation has occurred. The concept of proportionality in itself is broad and tribunals have applied it in different ways. Importantly, the tribunal in Tecmed v. Mexico demanded that the authorities' response be necessary to achieve the intended public interest.

– **Legitimate objective of the measure:** In the Santa Elena v. Costa Rica award, an arbitration tribunal ruled that "expropriatory environmental measures – no matter how laudable and beneficial to society as a whole – are, in this respect, similar to any other expropriatory measures that a state may take in order to implement its policies: where property is expropriated, even for environmental purposes, whether domestic or international, the state's obligation to pay compensation remains."[67]

These guiding criteria as developed by case law help define the term indirect expropriation to some extent. However, the **case law is not consistent, and is sometimes contradictory**. The distinction between what constitutes indirect expropriation and what government action does not require compensation remains poorly articulated.[68] The outcome of arbitration largely depends on whether the tribunal leans towards the sole effect doctrine or focuses on the purpose and context of the measure, in line with the so called police-power doctrine. The latter is less restrictive of governments' regulatory freedom.[69]

This is illustrated by the following cases:

– **Methanex v. USA:** Methanex, the claimant, was one of the leading manufacturers of methanol for the US market. Methanol was used as a gasoline additive. Following studies showing the damaging effect of methanol on water, California banned methanol. According to the claimant, the ban constituted a violation of the FET clause and an indirect expropriation. The tribunal rejected these claims. Specifically, the tribunal held: "But 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 alios, 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."[70]

– **Glamis Gold Ltd vs. United States:** The claimant, Glamis Gold Ltd., sought a mining permit for a project in California. During the licensing process, California adopted new mining rules. The new rules set more stringent environmental standards and introduced new requirements for the protection of cultural heritage sites. Glamis Gold Ltd. expected significant losses in profits due to these new rules. The claimant initiated arbitration under NAFTA, alleging, among other things, an indirect expropriation and a violation of the FET principle. The tribunal rejected these claims. The tribunal argued that the claimant's losses were not significant enough to constitute an indirect expropriation and that the measures were not expropriatory in nature. More specifically, the tribunal stated that mere restrictions on property rights did not constitute expropriation. An indirect expropriation would require that "the claimant was radically deprived of the economic use and enjoyment of its investment, as if the rights thereto … had ceased to exist". It found that a reduction of expected profits in the range of about 55% did not constitute an indirect expropriation.[71]

### 3.1.3 Umbrella clause

Umbrella clauses convert a contract claim, i.e. a claim based on a specific contract between two parties under civil law, into a treaty claim, i.e. a claim under public international law. For example, if an IIA contains an umbrella clause, an investor could claim the violation of the IIA because the host country allegedly had violated a private contract (on buying a public building or payment for certain services, for example). The investors could bring this claim before an arbitration tribunal. By contrast, under national law, contract-related claims are normally settled by domestic civil courts or, when a public body is a party to the contract – an administrative court. Thus, umbrella clauses give investors a judicial redress mechanism they would not otherwise have for their contractual claims.

67 Compañia del Desarrollo de Santa Elena, S.A. and The Reblic of Costa Rica Case No. ARB/96/1.
68 OECD, *"Indirect Expropriation" and the "Right to Regulate" in International Investment Law.*
70 Methanex Corp. v. United States of America (Methanex v. United States), p. 4, para. 7.
71 Glamis Gold Ltd. v. United States of America (Glamis v. United States), Nathalie Bernasconi-Osterwalder and Lise Johnson International Investment Law and Sustainable Development, Key Cases from 2000-2010, p. 63.

Umbrella clauses are a common feature of many investment treaties.

Often umbrella clauses read:

"Each contracting Party shall observe any obligations it has entered into with an Investor or an Investment of an Investor of any other Contracting Party" (Article 10. 1 Energy Charter Treaty).

This is a far-reaching example, converting **all obligations**, including obligations under a private contract, into a claim under the Treaty. Other clauses have a narrower scope, elevating only specific obligations to a treaty claim. Article 10 Australia-Poland BIT 1991 is an example:

"A Contracting Party shall, subject to its law, do all in its power to ensure that a written undertaking given by a competent authority to a national of the other Contracting Party with regard to an investment is respected."

Practically speaking, umbrella clauses are quite important. Umbrella clauses transform **contractual obligations** (e.g. from a building contract) into international obligations. Accordingly, an investor can bring related claims directly before an international arbitral body; an umbrella clause removes the requirement for investors to file a claim with national courts. Therefore, investors often rely on an umbrella clause as a catch-all provision to pursue claims when a host state's actions do not otherwise breach the BIT.[72] Lawyers involved in ISDS call umbrella clauses a "powerful tool for foreign investors in the event of contractual dispute with a host state".[73] From an environmental point of view, the main problem with umbrella clauses is that they protect investments that comply with a private contract, but which might not be in line with national laws, such as environmental regulations.[74]

In international case law, umbrella clauses have been interpreted in multiple ways, depending on their wording and context:

- In **Joy Mining Machinery Limited v. The Arabic Republic of Egypt**, the tribunal held that an umbrella clause found in the treaty, though not very prominently, could not have the effect of transforming all contractual disputes into investment disputes under the Treaty. This would only be the case, the tribunal argued, if a violation of contract rights was of such a magnitude as to trigger treaty protection, which was taken not to be the case in this dispute.[75]

- In contrast to this case, a tribunal in **Eureko B. V. v. Poland** adopted a broad interpretation of the respective umbrella clause.[76] In consequence, all contractual obligations were protected by the investment treaty and subject to the jurisdiction of the tribunal.

Tribunals have usually applied general and inclusive umbrella clauses rather broadly.[77]

Umbrella clauses can have far-reaching consequences for environmental policies, in particular when formulated broadly. In such cases, a contractual obligation by the host state on environmental or related matters could become the subject of ISDS.

### 3.1.4 Conclusions

The above ISDS case law illustrates the importance of investment arbitration for environmental policy making. Although tribunals never annul environmental regulations or have any similar direct impact on national environmental policies, they have – in some cases – awarded substantial compensation to investors. Investors would have been **unlikely to obtain a similar decision under national law**. Even if a government's behavior is ultimately considered to be lawful, the government is forced to defend its regulatory decisions before an international tribunal, which often entails bearing significant costs for the investment proceedings.

The inclusion of any of the above norms in TTIP would not automatically mean that the US and EU would be unable to adopt environmental measures in the future or would have

72 Umbrella Clause, http://uk.practicallaw.com/8-519-0939

73 Ethan G. Shenkman and D. Jason File, "Recent Developments in Investment Treaty Jurisprudence: Arbitrating Contract Claims under Umbrella Clauses," in *The International Comparative Legal Guide to Arbitration 2007,* 2007, 6-9, http://www.wilmerhale.com/uploadedFiles/WilmerHale_Shared_Content/Files/Editorial/Publication/ShenkmanFile2007_intlarb.pdf

74 Fauchald, "International Investment Law and Environmental Protection," 27.

75 ICSID case No ARB/03/11, August 6, 2004.

76 Eureko B.V. v. Poland, Partial Award, 19 August 2005, http://www.investmentclaims.com/decisions/Eureko-Poland-LiabilityAward.pdf

77 OECD, *Interpretation of the Umbrella Clause in Investment Agreements,* Working papers on international investment (OECD: Paris, October 2006), 22, http://www.oecd.org/investment/internationalinvestmentagreements/37579220.pdf

to pay compensation to investors whenever doing so; however, the outcome of ISDS proceedings is rather unpredictable – the case law so far is inconsistent. Decisions from some cases have been quite restrictive of governments' regulatory freedom. These uncertainties result in considerable risks which are exacerbated by the fact that investment-related provisions tend to be interpreted broadly in ISDS proceedings.[78]

The fact that an investor could threaten a government with ultimately resorting to ISDS may also influence negotiated solutions (e.g. in the Vattenfall case described above).

Equally, the threat of investment arbitration could have a **chilling effect** on governments' willingness to adopt environmental regulation. It could lead governments to not adopt planned measures, to adopt less ambitious regulations, or to agree on a negotiated solution with investors.[79]

## 3.2 Phrasing rules on investment protection differently – a solution?

The previous section described why the interpretation of certain rules on investment protection in ISDS cases presents real risks for governments adopting environmental regulations – they may have to compensate investors or may be deterred from taking such measures in first place. One possibility to reduce such risks could be to phrase agreements differently from existing IIAs; this is indeed what the EU has proposed. In the following we look at the potential of two approaches: first, including exception clauses in favor of environmental regulations, second adding detailed explanations of some central terms like "indirect expropriation" or "FET" to agreements.[80]

### 3.2.1 Exception clauses

Some investment treaties explicitly **affirm the right of States to protect specific public interests** and take measures accordingly. These provisions generally stipulate that none of the treaty provisions shall prevent the contracting States from taking measures necessary to protect certain public interests, such as public health, the environment, national security, or maintenance and improvement of labor rights. For example, Art. 1114.1, Chapter 11, of NAFTA, entitled "Environmental Measures" states:

> "Nothing in this Chapter shall be construed to prevent a Party from adopting, maintaining or enforcing any measure otherwise consistent with this Chapter that it considers appropriate to ensure that investment activity in its territory is undertaken in a manner sensitive to environmental concerns."

Similarly the **EU' Commission's negotiating mandate** states that investment protection clauses should be

> "without prejudice to the right of the EU and the Member States to adopt and enforce, in accordance with their respective competences, measures necessary to pursue legitimate public policy objectives such as social, environmental, security, stability of the financial system, public health and safety in a non-discriminatory manner."

The question is whether such clauses ensure that no measure, adopted by a state in a manner lawful under national law and aimed at environmental protection could be considered to violate any of the clauses above (FET, prohibition of expropriation, umbrella clause). Obviously, this would depend to an extent on the precise wording of the exception norms.

However, the potential of such exemption norms for preventing undesirable decisions by arbitrators is limited. After all, stressing a "right to regulate" is stating the obvious – states do have that right under international law in any case.[81] Moreover, depending on the way exceptions are formulated, they may carve out policy space for certain regulatory objectives, but not for other equally important regulatory objectives.[82]

Some **lessons on exception clauses** can be learned from the experience at the World Trade Organization (WTO). GATT, the WTO agreement regulating trade in goods and forbidding WTO Members from enacting certain trade-related measures (e.g. import bans), contains a general exception norm, Art. XX. This article states, among other things, that

78 See Public statement on the international investment regime, 31 August 2010, http://www.osgoode.yorku.ca/public-statement/documents/Public%20Statement%20%28June%202011%29.pdf, para. 5.
79 See Fauchald, "International Investment Law and Environmental Protection," 9.
80 A brief overview of other mechanisms dealing with environmental objectives in international investment law is provided by ibid., 6, 38ff.
81 Nikièma, *Best Practices Indirect Expropriation*, 9.
82 UNCTAD, *Expropriation*, UNCTAD Series on Issues in International Investment Agreements (New York: United Nations, 2012), 90.

measures taken for certain public policy purposes (e.g. human health) must be necessary for this purpose. Art. XX GATT has occasionally been replicated in IIAs.[83]

The term "necessary", also contained in the EU Commission's proposal cited above, appears unproblematic and reasonable: who would want a public decision-maker to take "unnecessary measures"? However, the term is an easy hurdle to pass in WTO dispute settlement mechanism. The concept of necessity is difficult to interpret, because the term itself is broad and vague. The WTO dispute settlement bodies, in determining whether a measure is necessary, engage in a balancing exercise, taking into account the importance of the interest protected, the contribution of the measure to the end pursued, and the degree to which it restricts trade. In addition, there must not be a less trade-restrictive measure that is equally effective in reaching a WTO Member's desired level of protection.[84] Even though the WTO dispute settlement bodies confirm the sovereign right of WTO Members to choose a level of protection they consider appropriate, they have engaged in intensive scrutiny of measures taken for this purpose. In practice, WTO tribunals have repeatedly considered measures "unnecessary" or incompatible with the WTO necessity standards.[85]

Against this background, the **impact of such exception provisions on the outcome of actual cases is likely to be limited**; such clauses could be seen as providing false comfort. They relieve governments neither from the burden of justifying their regulatory measures in front of an international tribunal of private individuals nor from the risk of being forced to pay compensation.

### 3.2.2 Defining critical terms

A different option would be to **define concepts** such as FET and indirect expropriation precisely. Some existing IIAs pursue this model. The US model BIT, for example, defines its central terms in detail. It states that expropriations of investments are prohibited, except when undertaken for a public purpose, in a non-discriminatory manner, and on payment of compensation. Annex 2 of the US model BIT also defines factors to be considered in determining whether a measure constitutes an indirect expropriation; it says explicitly that, except in rare circumstances, non-discriminatory regulatory actions by a party, designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations.

Again, the effect of such clauses depends, to a degree, on the way they are formulated. Generally, vague norms delegate decisions to the judiciary. Precise norms, in contrast, reduce the discretionary decision-making space for judges. Thus, if ISDS provisions are included in TTIP, a definition of its central investment-related terms the minimum required to prevent investment dispute awards from becoming too intrusive upon the Parties regulatory space. Negotiators can, to this end, draw on existing models and proposals.[86]

### 3.2.3 Conclusions

From an environmental viewpoint, ISDS provisions in TTIP are clearly not desirable. However, given that both the EU Commission and US trade negotiators have made clear that they would like to see ISDS provisions in TTIP, it is worth thinking about how these investment-related provisions should be phrased in order to **minimize risks to environmental regulation**.

In the light of the discussion above, the following **recommendations** can be made:

- Clauses that have been proven critical with regard to environmental action taken by governments in investment-related case law so far should (notably FET, indirect expropriation, umbrella clause) either not be included in TTIP or if they are included, they should be defined precisely. Such definitions should explicitly state that non-discriminatory measures taken for a public policy purpose defined by the respective government and observing due process guarantees can never be taken to violate TTIP. Such clauses are preferable over exception norms for environmental or other measures.

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83 For example, Art. 8 (3) c of the US model BIT; see also Art. 2101 NAFTA.

84 Most relevant are the Appellate Body's decisions in the following cases: Korea – Measures Affecting Imports of Fresh, Chilled and Frozen Beef (WTDS161/169), Brazil – Measures Affecting Imports of Retreaded Tyres (WT/DS332), Dominican Republic – Measures Affecting the Importation and Internal Sale of Cigarettes (WT/DS302).

85 However, WTO case law is rather ambiguous, a fact that has garnered a good deal of criticism among legal observers, see Arwel Davies, "Interpreting the Chapeau of GATT Art. XX in Light of the 'New' Approach in Brazil Tyres," *Journal of World Trade* 43, no. 3 (2009): 507–539; Chad P. Bown and Joel P. Trachtman, "Brazil – Measures Affecting Imports of Retreaded Tyres: A Balancing Act," *World Trade Review* 8, no. 1 (2009): 85-135.

86 For example, suggestions on how to formulate clauses relating to expropriation are contained in UNCTAD, *Expropriation*, 125ff.

- The exhaustion of domestic remedies should be made a pre-condition for investors before being allowed to initiate ISDS procedures. Both the US and EU legal systems provide investors with recourse to efficient, rule of law judicial procedures – it is not evident why foreign investors should not use these in the same manner that domestic investors do.

- Provisions should be included to address certain institutional and procedural shortcomings of existing approaches to ISDS. On both the US and the EU side useful proposals have been formulated in this context. In particular, the proceedings' transparency must be enhanced. Additionally, provisions on conflicts of interest among arbitrators and a full legal review mechanism for investment awards should be developed.

# 4 ISDS under TTIP – a contested instrument

There are a wide range of positions on the use of ISDS in TTIP. The following chapter investigates the stated positions of the US and the EU (including its Member States), of business associations and of civil society organizations respectively. In a final section, we will discuss these positions, drawing also on some general insights from existing literature on the benefits and drawbacks of ISDS.

## 4.1 EU and US

Within the **EU**, the Commission's negotiating mandate is the defining document for TTIP negotiations. The relevant parts of the text are reproduced in the Annex; it states that the inclusion of investment protection and investor-state dispute settlement (ISDS) will depend on whether a satisfactory solution is found to certain concerns of the EU. Some of these concerns, relating to the substantive side of investment rules, have already been discussed. However, the mandate also contains a particular qualification of procedural aspects of ISDS:

> "the Agreement should aim to provide for an effective and state-of-the-art investor-to-state dispute settlement mechanism, providing of transparency, independence of arbitrators and predictability of the Agreement, including through the possibility of binding interpretation for the Agreement by the Parties. … It should provide for investors as wide a range of arbitration for a as is currently available under the Member States' bilateral investment agreements. The investor-to-state dispute settlement mechanism should contain safeguards against manifestly unjustified or frivolous claims. Consideration should be given to the possibility of creating an appellate mechanism applicable to investor-to-state dispute settlement under the Agreement, and to the appropriate relationship between ISDS and domestic remedies."

In other statements, the EU Commission has indicated that it would, in future investment treaties, seek to include mechanisms to:

- prevent investors from bringing multiple or frivolous claims (investors who lose a case will be obliged pay all litigation costs, including those of the state);

- make the arbitration system more transparent, documents available to the public, access to hearings and allow interested parties (e.g. NGOs) to make submissions; and

- deal with conflicts of interest and consistency of arbitral awards (e.g. introduction of a binding code of conduct for arbitrators).

A regulation on splitting up eventual financial burdens resulting from ISDS within the EU is still in the EU legislative process.[87]

87 Regulation of the European parliament and of the Council establishing a framework for managing financial responsibility linked to investor-state dispute settlement tribunals established by international agreements to which the European Union is party , Brussels, 21.6.2012, COM(2012) 335 final, 2012/0163 (COD).

However, in January 2014 the EU Commission responded to public criticism on ISDS in TTIP. It announced to hold a public consultation on the proposed EU text for the investment part of TTIP, which will include sections on investment protection and on ISDS.[88] According to press reports, the Commission will also suspend negotiations on the investment chapter in TTIP until the consultation is carried out.[89] In an accompanying statement, EU Trade Commissioner de Gucht said:

> "... some existing arrangements have caused problems in practice, allowing companies to exploit loopholes where the legal text has been vague. ... I have been tasked by the EU Member States to fix the problems that exist in current investment arrangements and I'm determined to make the investment protection system more transparent and impartial, and to close these legal loopholes once and for all."

In an accompanying interview, de Gucht made the point that ISDS was necessary from the viewpoint of EU companies, because US courts were reluctant to enforce international treaties.[90] As de Gucht's statement above also implies, there is not a full consensus among EU Member States on including ISDS in TTIP. For example, the German Federal Ministry for the Economy and Technology (BMWi) expressed doubts as to whether arbitration proceedings could offer EU investors more effective legal protection. According to the ministry, national remedies should come first and there should be protection against ill-founded claims.[91] A Dutch MEP also stated that "though the twenty-eight EU Member States themselves jointly approved the TTIP mandate, some of them are not quite pleased with the inclusion of ISDS."[92]

On the **US** side, the model BIT has extensive provisions on ISDS.[93] These include some that depart from predominant models. For example, the model BIT stipulates in Art. 28.3 that arbitration tribunals shall have the right to accept so called amicus curiae submissions, statements by third parties interested in the case, such as NGOs. Art. 29 also sets forth that the documents relating to a dispute (e.g. submissions by the parties) must be made public. This implies a much higher degree of transparency for such disputes than is now common.

Altogether, the US and EU sides appear to have mostly convergent positions on the fact that ISDS should become part of TTIP. In addition, they also appear to agree that some of the shortcomings of the existing ISDS system should be remedied, including the lack of transparency.

## 4.2 Business sector

Business communities generally **support strong, substantive guarantees on investment, as well as provisions on ISDS in TTIP**. For example, the EU branch of the US Chamber of Commerce (AmCham EU) states that, in the investment area, TTIP should aim for regulatory stability and legal certainty. In this context it refers to several pieces of EU environmental legislation that allegedly undermine such certainty, including the EU's chemical regulatory framework (REACH), the Water Framework Directive (WFD), and the Restriction of Hazardous Substances Directive (RoHS II). It also makes clear that investor-state arbitration is strongly supported by the US business community.[94] Similarly, the director of Business Europe, a leading business association at the European level, called for a "state of the art" investor-state arbitration mechanism in TTIP.[95] On the other hand, a representative of the leading German business association

88 European Commission, DG Trade, *Commission to consult European public on provisions in EU-US trade deal on investment and investor-state dispute settlement*, Press release 21 January 2014, http://trade.ec.europa.eu/doclib/press/index.cfm?id=1015

89 Interview with Karel de Gucht, *Wir verteidigen hier europäische Interessen, Deutschlandfunk*, 23 January 2014, http://www.deutschlandfunk.de/freihandelsabkommen-wir-verteidigen-hier-europaeische.697.de.html?dram:article_id=275391

90 Interview with Karel de Gucht, *Wir verteidigen hier europäische Interessen, Deutschlandfunk*, 23 January 2014, http://www.deutschlandfunk.de/freihandelsabkommen-wir-verteidigen-hier-europaeische.697.de.html?dram:article_id=275391

91 US-German Standards Panel, Washington DC, Monday, 15 October 2013, Prospects for a Transatlantic Trade and Investment Partnership – a German Perspective, Presentation by Dr. Berend Diekmann Head of Division External Economic Policy, G8/G20, OECD, USA, Canada, Mexico, http://www.din.de/sixcms_upload/media/2896/Section%202_Diekmann_Presentation%20DIN%20ANSI%20TTIP.pdf

92 Does pursuing investment protection in TTIP signal more transatlantic mistrust?, 15 November 2013, http://www.marietjeschaake.eu/2013/11/does-pursuing-investment-protection-in-ttip-signal-more-transatlantic-mistrust/

93 It has been observed that most US investment treaties closely follow the model BIT, so it can be taken as indicative of the US position, see Lauge N. Skovgaard Poulsen, Jonathan Bonnitcha, and Jason Webb Yackee, *Costs and Benefits of an EU-USA Investment Protection Treaty* (LSE Enteprise, April 2013), 6, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/260380/bis-13-1284-costs-and-benefits-of-an-eu-usa-investment-protection-treaty.pdf

94 AmCham EU's reply to USTR's Request for Comments Concerning Proposed Transatlantic Trade and Investment Partnership, 21 May 2013, p. 28, http://www.amchameu.eu/DesktopModules/Bring2mind/DMX/Download.aspx?TabId=165&Command=Core_Download&EntryId=9011&PortalId=0&TabId=165

95 A new era for EU – US Trade, Speech by Markus J. Beyrer, Business Europe Director General, 7 October 2013, http://www.businesseurope.eu/DocShareNoFrame/docs/1/CBDIOKCAOGLBLBJMHCJMODGKPDW69DWDGK9LTE4Q/UNICE/docs/DLS/2013-01044-E.pdf

(BDI) also expressed support for improving existing ISDS models. He indicated that there was a need for preventing frivolous claims, including clear definitions of central concepts and procedural rules that ensure transparency, but also protect legitimate business interests.[96]

Interestingly, however, while these calls for including ISDS provisions in TTIP are being made, none of the above statements provides specific arguments why. Notably, there are no complaints that the existing level of judicial protection in the US or the EU is insufficient for investors.

## 4.3 Civil society

By contrast, several civil society organizations have **expressed concern** over an investment protection chapter and over ISDS in particular. The broadest civil society statement on ISDS in TTIP is a letter of December 2013, signed by more than 200 civil society organizations from both sides of the Atlantic, as well as from other continents.[97] In this letter, addressed to EU Trade Commissioner Karl de Gucht, the civil society organizations urge him to exclude ISDS from TTIP.

The letter claims that "ISDS forces governments to use taxpayer funds to compensate corporations for public health, environmental, labor and other public interest policies and government actions", referring to current or past ISDS legislation on Egypt's minimum-wage increase, the Peruvian government's decision to regulate toxic waste, and Philip Morris' arbitration claims over anti-smoking laws in Uruguay and Australia. They state that ISDS undermines democratic decision-making and that European and US legal systems are capable of handling investment disputes, both having strong domestic court systems and property protection. The letter also demands that governments must have the flexibility to put in place public interest policies without fear of trade litigation launched by corporations.

96 BDI, „Schutzmechanismus gegen ungerechtfertigte Klagen", 22 January 2014, http://www.bdi.eu/163_18416.htm
97 Online at http://www.s2bnetwork.org/fileadmin/dateien/downloads/CivilSociety_TTIP_Investment_Letter_Dec16-2013_Final.pdf

# 5 Conclusions and policy recommendations

Broadly worded investment rules in TTIP in combination with giving investors the possibility to bring claims against their host states at the international level do not mean that the US or the EU will be legally precluded from taking any environmental measures in the future. They also do not mean that EU Member States or the US would inevitably or frequently have to pay compensation for such measures.

However, there is a c**onsiderable risk** that this would occur in at least a number of cases. Consequently, TTIP could also be used in political negotiations within the EU or the US as an argument for not adopting more stringent environmental standards. Additionally, given the magnitude of investment falling under TTIP, the agreement would allow a large number of companies to bypass national judicial systems, possibly at the expense of domestic competitors.

These risks for environmental regulation arising from including investment and ISDS provisions in TTIP must be balanced against their **possible benefits.** Rationales normally given for investment protection rules and ISDS are that investment would become more attractive; investors would be reassured that there is an efficient mechanism to safeguard their rights and economic interests, independent of potentially biased, inefficient or corrupt judicial mechanisms at the national level.[98] It is also argued, that by giving investors direct access to dispute settlement procedures, governments are relieved of the burden of taking action on behalf of their investors vis-á-vis a host state. In addition, the point has been made by EU Trade Commissioner de Gucht and others[99] that ISDS is necessary from the viewpoint of European companies, because US courts are reluctant to enforce international agreements domestically, i.e. investors could not rely on TTIP in US courts.

However, in the case of TTIP such **arguments for ISDS rules are rather weak**. Both the US and the EU have highly evolved, efficient rule of law legal systems. There is no evidence that investors have ever lacked appropriate legal protections through these systems. To the contrary, EU companies' investments in the US and US companies' investments in the EU have grown significantly over the last decade, without foreign investors having access to special dispute settlement mechanisms. Historically, ISDS provisions were included in IIAs where at least one of the parties did not have a functioning or neutral legal system. ISDS make sense to remedy the absence of functioning courts; however, they are superfluous, or even harmful, when state parties already strictly adhere to the rule of law, as the US and EU both do.

A recent study by the London School of Economics concludes that an EU-US investment treaty containing ISDS provisions is likely to have few or no benefits to the UK, while having significant economic and political costs. By contrast, the study's authors estimate that removing ISDS from the treaty would be unlikely to have an appreciable impact on the (already negligible) benefits of TTIP, while largely removing the costs of the treaty to the UK.[100] The study also observes that "not a single investment treaty with a developed country – including Canada, Australia, Israel, and Singapore – has had an impact on US investment outflows."[101]

US and EU investors already account for more than half of foreign direct investment in each other's economies. It has been pointed out that this is a clear signal that investors seem to be happy enough with the rule of law on both sides of the Atlantic.[102] Both EU Member States and the US perform well under indices assessing the rule of law in various countries, including with regard to criminal and civil justice.[103]

98 OECD, *Investor-State Dispute Settlement: Public Consultation: 16 May – 9 July 2012* (Paris: OECD, 2012), para. 21, http://www.oecd.org/investment/internationalinvestmentagreements/50291642.pdf
99 Helene Bubrowski, Schiedsgerichte sind gerechter, Frankfurter Allgemeine Zeitung, 25 January 2014, http://www.faz.net/aktuell/politik/staat-und-recht/freihandelsabkommen-schiedsgerichte-sind-gerechter-12768294.html
Poulsen, Bonnitcha, and Yackee, *Costs and Benefits of an EU-USA Investment Protection Treaty*, 9.
101 Ibid., 15.
102 Corporate Europe Observatory and Transnational Institute, *A Transatlantic Corporate Bill of Rights – Investor Privileges in EU-US Trade Deal Threaten Public Interest and Democracy,* 6.
103 See for example the "Rule of Law Index", http://worldjusticeproject.org/rule-of-law-index-data

Some governments of **OECD countries have expressed concerns** about the impact of ISDS on regulation. The Australian government, for example, adopted a policy not to include ISDS in future investment treaties with developing countries. It also stated that the Australian government "does not support provisions that would confer greater legal rights on foreign businesses than those available to domestic businesses" nor such "that would constrain the ability of Australian governments to make laws on social, environmental and economic matters in circumstances where those laws do not discriminate between domestic and foreign businesses".[104]

Finally, the argument that ISDS is necessary, because US courts are reluctant to enforce international agreements is not convincing, either. It is true that US case law presents a mixed picture with regard to if and to what extent complainants can rely on international agreements before US courts.[105] However, this is not unusual. International agreements are concluded between governments; the governments thereby assume an obligation to bring their national law in line with the agreement. Citizens and foreign nationals can then rely on national law; international agreements are not normally concluded with the objective of giving individuals or citizens enforceable individual rights. The Court of Justice of the European Union (CJEU), for example, gives companies the right to directly rely on norms of international trade law, notably WTO law, only in a very limited set of circumstances; thus, EU companies cannot normally rely on an alleged breach of WTO law to have EU law invalidated before the CJEU.[106] The US judicial system's position is thus not unusual at all. It does not result in a lack of appropriate protections for investors or citizens, either – they are protected by the national legal systems of the US, the EU, and the EU Member States. For example, in the German legal system, a right to property is guaranteed by Art. 14 of the constitution; the article also sets forth that there must not be any expropriation without compensation. An investor facing expropriation can hence resort to a German court for a review of the legality of the expropriation, including the amount of compensation offered.

A logical corollary of the above would be **rejecting the inclusion of ISDS** in TTIP. From the viewpoint of potential risks to environmental regulation this would be the safest and most highly recommended option. However, if policymakers in the US and the EU decide to include ISDS provisions after all, these provisions must be formulated in a narrow and precise manner, in order to minimize any risks for environmental regulation.

Ultimately, a reorientation of international investment law is highly desirable from an environmental point of view; a new generation of treaties should not focus on investors' rights only, but define investors' (environmental) obligations as well.

104 Gillard Government Trade Policy Statement:Trading our way to more jobs and prosperity, April 2011, http://www.acci.asn.au/getattachment/b9d3cfae-fc0c-4c2a-a3df-3f58228daf6d/Gillard-Government-Trade-Policy-Statement.aspx

105 For an in-depth discussion of US case law, see Oona A. Hathaway, Sabria McElroy, and Sara Aronchick Solow, "International Law at Home: Enforcing Treaties in U.S. Courts," *Yale Journal of International Law* 37, no. 1 (2011): 51-106, http://www.yjil.org/docs/pub/37-1-hathaway-international-law-at-home.pdf

106 For details on the CJEU's case law, see Christiane Gerstetter et al., *Legal Implications of TTIP for the Acquis Communitaire in ENVI Relevant Sectors* (Brussels: European Parliament, 2013), http://www.ecologic.eu/sites/files/project/2013/Gerstetter-2013-Legal-Implications-of-TTIP-for-the-AC-and-the-ENVI-Relevant-Sectors.pdf

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# Annex: Legal provisions

## Text of the EU Commission's negotiation mandate on TTIP relating to investment protection (paras. 22-23 of the mandate)

22. The aim of negotiations on investment will be to negotiate investment liberalisation and protection provisions including areas of mixed competence, such as portfolio investment, property and expropriation aspects, on the basis of the highest levels of liberalization and highest standards of protection that both Parties have negotiated to date. After prior consultation with Member States and in accordance with the EU Treaties the inclusion of investment protection and investor-to-state dispute settlement (ISDS) will depend on whether a satisfactory solution, meeting the EU interests concerning the issues covered by paragraph 23, is achieved. The matter shall also be considered in view of the final balance of the Agreement.

23. As regards investment protection, the objective of the respective provisions of the Agreement should:

- provide for the highest possible level of legal protection and certainty for European investors in the US;
- provide for the promotion of European standards of protection which should increase Europe's attractiveness as destination for foreign investment;
- provide for a level playing field for investors in the US and in the EU;
- build upon the Member States' experience and best practice regarding their bilateral investment agreements with third countries;
- and should be without prejudice to the right of the EU and the Member States to adopt and enforce, in accordance with their respective competences, measures necessary to pursue legitimate public policy objectives such as social, environmental, security, stability of the financial system, public health and safety in a non-discriminatory manner. The Agreement should respect the policies of the EU and its Member States for the protection and promotion of cultural diversity.

**Scope:** the investment protection chapter of the Agreement should cover a broad range of investors and their investments, intellectual property rights included, whether the investment is made before or after the entry into force of the Agreement.

**Standards of treatment:** the negotiations should aim to include in particular, but not exclusively, the following standards of treatment and rules:

- fair and equitable treatment, including a prohibition of unreasonable, arbitrary or discriminatory measures;
- national treatment;
- most-favored nation treatment;
- protection against direct and indirect expropriation, including the right to prompt adequate and effective compensation;
- full protection and security of investors and investment;
- other effective protection provisions, such as an "umbrella clause";
- free transfer of funds of capital and payments by investors;
- rules concerning subrogation.

**Enforcement:** the Agreement should aim to provide for an effective and state-of-the-art investor-to-state dispute settlement mechanism, providing of transparency, independence of arbitrators and predictability of the Agreement, including through the possibility of binding interpretation for the Agreement by the Parties. Sate-to-state dispute settlement should be included, but should not interfere with the right of investors to have recourse to their investor-to-state dispute settlement mechanisms. It should provide for investors as wide a range of arbitration for a as is currently available under the Member States' bilateral investment agreements. The investor-to-state dispute settlement mechanism should contain safeguards against manifestly unjustified or frivolous claims. Consideration should be given to the possibility of creating an appellate mechanism applicable to investor-to-state dispute settlement under the Agreement, and to the appropriate relationship between ISDS and domestic remedies.

## Energy Charter Treaty

ARTICLE 10: PROMOTION, PROTECTION AND TREATMENT OF INVESTMENTS

(1) Each Contracting Party shall, in accordance with the provisions of this Treaty, encourage and create stable, equitable, favourable and transparent conditions for Investors of other Contracting Parties to make Investments in its Area. Such conditions shall include a commitment

to accord at all times to Investments of Investors of other Contracting Parties fair and equitable treatment. Such Investments shall also enjoy the most constant protection and security and no Contracting Party shall in any way impair by unreasonable or discriminatory measures their management, maintenance, use, enjoyment or disposal. In no case shall such Investments be accorded treatment less favourable than that required by international law, including treaty obligations.

Each Contracting Party shall observe any obligations it has entered into with an Investor or an Investment of an Investor of any other Contracting Party.

ARTICLE 13: EXPROPRIATION

(1) Investments of Investors of a Contracting Party in the Area of any other Contracting Party shall not be nationalized, expropriated or subjected to a measure or measures having effect equivalent to nationalization or expropriation (hereinafter referred to as "Expropriation") except where such Expropriation is:

(a) for a purpose which is in the public interest;
(b) not discriminatory;
(c) carried out under due process of law; and
(d) accompanied by the payment of prompt, adequate and effective compensation.

Such compensation shall amount to the fair market value of the Investment expropriated at the time immediately before the Expropriation or impending Expropriation became known in such a way as to affect the value of the Investment (hereinafter referred to as the "Valuation Date").

Such fair market value shall at the request of the Investor be expressed in a Freely Convertible Currency on the basis of the market rate of exchange existing for that currency on the Valuation Date. Compensation shall also include interest at a commercial rate established on a market basis from the date of Expropriation until the date of payment.

Article 19 ENVIRONMENTAL ASPECTS

In pursuit of sustainable development and taking into account its obligations under those international agreements concerning the environment to which it is party, each Contracting Party shall strive to minimize in an economically efficient manner harmful Environmental Impacts occurring either within or outside its Area from all operations within the Energy Cycle in its Area, taking proper account of safety. In doing so each Contracting Party shall act in a Cost-Effective manner. In its policies and actions each Contracting Party shall strive to take precautionary measures to prevent or minimize environmental degradation. The Contracting Parties agree that the polluter in the Areas of Contracting Parties, should, in principle, bear the cost of pollution, including transboundary pollution, with due regard to the public interest and without distorting Investment in the Energy Cycle or international trade. Contracting Parties shall accordingly:

- take account of environmental considerations throughout the formulation and implementation of their energy policies;
- …

i) promote the transparent assessment at an early stage and prior to decision, and subsequent monitoring, of Environmental Impacts of environmentally significant energy investment projects;

## Canadian model Bilateral Investment Treaty, Annex B.4

The determination of whether an action or series of actions by a Party, in a specific fact situation, constitutes an indirect expropriation, requires a case-by-case, fact-based inquiry that considers, among other factors:

(i) the economic impact of the government action, although the fact that an action or series of actions by a Party has an adverse effect on the economic value of an investment, standing alone, does not establish that an indirect expropriation has occurred;

(ii) the extent to which the government action interferes with distinct, reasonable investment-backed expectations; and

(iii) the character of the government action.