SVENSKT NÄRINGSLIV
SWEDISH ENTERPRISE

Facts about
investment protection regulations

Investment protection regulations

Investor-to-State Dispute Settlement (ISDS)

Preface

EU negotiations with the US on a Transatlantic Trade and Investment Partnership (TTIP) are being carried out based on a mandate approved by the democratically elected leaders of the EU member states. Once negotiations are completed, all documentation relating to the agreement will be published. The final trade agreement must be approved by all EU member states and the European Parliament.

ISDS is – in short – the right of companies and individuals, who consider that a breach of an investment protection treaty to have occurred, to force a host state before an international board of arbitration with claim for economic compensation. In such a board each party typically chooses its own representative, and these then together choose a chairperson. The verdict of the board is not subject to appeal.

This paper does not provide a complete survey of the legal institution constituted by ISDS. In brief, its purpose is:

a. to illuminate the significance of ISDS to the European business community in general and Sweden in particular,

b. to evaluate the relative significance, for the Swedish and European business communities, of a TTIP agreement including such regulations, and

c. to propose modifications of the current regulations which might alleviate fears about potential interference with the democratic decision-making processes of states.

Why do investment protection regulations and ISDS matter to the business community?

a. Significance of ISDS for the European business community and for Sweden

International trade promotes growing prosperity and is relatively easy to tax. Uncertainty and a lack of permanent legal institutions stand in the way of trade and are thus reducing the potential profitability of companies and eroding the projected tax base of states. This is precisely why states began establishing ‘friendship, trade and navigation agreements’ centuries ago. Such agreements formed the basis for what later evolved into bilateral investment treaties, or BITs. Obviously, the risk of having its foreign assets expropriated (confiscated, nationalised or the like) without acceptable compensation, or being subjected to discriminatory measures by a host state, reduces a company’s willingness to invest in another country. It can thus be assumed to suppress the economic development of both the company and the host country. It is theoretically difficult to establish the positive economic effects of BITs, since too many assumptions in any such calculation have to be counterfactuals – it’s impossible to carry out a practical experiment in which you both have and don’t have a BIT between the same two countries. It’s also very difficult to compare countries that have BITs with countries that don’t, since the conditions are never the same. On the other hand, the very prevalence of BITs clearly suggests that they’re beneficial to both parties; otherwise there would scarcely be so many in force.

Initially, BITs were typically established between developed and developing countries. In recent years, however, many treaties have been established between countries on a relatively equal economic footing, such as the BIT between Sweden and former members of COMECON/Warsaw Pact. Further, many transitional economies, such as Brazil, India and China, are becoming more and more important to the international economic system, and are attracting a growing percentage of international investment streams. Demand for legal protection against undue encroachment on property rights in these countries is on the rise. Demand for investment protection between fully developed economies seems to be on the rise, too. The reason is that both the total volume of investments in such countries is enormous, and that major political intrusion into the activities of companies is increasingly common – even measures that amount to de facto expropriation without compensation seem to be growing more common. A complicating factor is that the rule of law and the legal certainty we westerners often smugly imagine we enjoy are not actually always so strong. The US jury system itself could result in bias that would negatively impact foreign companies in a dispute between them and, for example, a US member state. In countries outside the EU, confidence in the independence of the judicial system within the EU is not at all as strong as we may imagine, especially when the issue in question is a dispute between a foreign company and a state.

As of 2012, the OECD countries'[1] collective FDI assets were equal to 41 percent of their GDP. The same year, Swedish companies' foreign assets totalled fully 77 percent of Sweden's GDP[2]. Several EU member states – Luxembourg, Belgium, Ireland and the Netherlands – have foreign assets exceeding 100 percent of their GDP – with figures ranging from 289 to 128 percent. The EU had a total of SEK 66 trillion in FDI assets, of which little Sweden accounted for SEK 2,728 billion. The EU giants are the UK, France and Germany, with 12.1, 10.4 and 10.4 trillion in foreign assets, respectively.

Worldwide, there are currently about 3,000 BITs or investment protection sections included in free trade agreements. With the passage of time, ISDS has come to be the preferred dispute resolution mechanism. One strong reason for this is that it provides an ability for individual companies to address a state they believe has breached an agreement without involving their own country's government, thus avoiding the politicisation of investment disputes. States are very reluctant to disrupt their interstate relations in other areas, which are typically much more important to them than some particular compensation case. Another reason is that arbitration in an ISDS case is legally enforceable in 150 states pursuant to a 1958 international agreement known as the New York Convention. The OECD estimates that 93 percent of all BITs include ISDS provisions.

According to UNCTAD[3], to date 98 states have received claims in which ISDS formed the basis for the plaintiff 's standing. (This can be compared with the WTO[4], which to date has taken up 478 cases for arbitration – i.e. cases in which states have considered it so important to protect their trade interests that they have taken legal action against another state.)

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[1] The OECD is a cooperative organisation of the most developed economies in the world. The abbreviation stands for Organization of Economic Cooperation and Development.
[2] GDP = Gross Domestic Product, the total value of all production in a country during one year.
[3] United Nations Conference on Trade and Development.
[4] The World Trade Organisation. The WTO arbitrates disputes between member states.

Of the ISDS cases, at this writing 274 have been adjudicated, 43 percent in favour of the state involved and 31 percent in favour of the plaintiff company. In 26 percent of the cases, the parties have settled. Three international agreements accounted for a significant percentage of the cases adjudicated: the North American Free Trade Agreement (NAFTA) accounted for 51 cases, the Energy Charter Treaty (ECT) for 42 (which is the legal basis for the Swedish power company Vattenfall's case against Germany), and the BIT between Argentina and the US for 17. Another 72 cases originated in BITs between EU member states. Investors from developed countries accounted for the majority of the complaints. To date, 125 have come from the US, 61 from the Netherlands, 42 from the UK and 39 from Germany.

From the EU came 225 complaints, and in the past 30 years, more have come from companies in EU countries than in the US. It's not just big companies that turn to ISDS – an OECD study shows that 22 percent of complaints were brought by individuals or small companies. Medium-sized and large companies accounted for 50 percent of cases, and in the other 28 percent, there's no public information on the plaintiff.

As the above data indicates, ISDS is a by no means inconsequential component in the protection of foreign investment assets. On the contrary, it seems quite noteworthy that in more than 500 cases in recent decades, companies have considered themselves so mistreated that they have gone to arbitration. The first instinct of companies, of course, is to try to resolve disputes in good faith, in particular if the counterparty is a state, with the power and resources a state has at its disposal. Even a small state is typically large compared to a company. In addition, companies have to take into account that it could have a negative impact on their future operations in the state – state bureaucrats have enormous practical opportunities to harass or hinder a company. In many countries, a de facto blacklisting is not unlikely to be the result of a case brought pursuant to an investment protection agreement.

A recent example that has been in the news is Argentina's decision to nationalise the Argentinian assets (consisting of a majority share of the oil company YPF) of a Spanish company, Repsol, without adequate compensation. Their holdings in Argentina were valued by Repsol itself at \$10.5 billion. Repsol initiated a case to bring Argentina before an arbitration board pursuant to the BIT between Argentina and Spain, but ultimately accepted a settlement in which they received \$5 billion (in Argentine bonds) in return for their shares. If there had not been a BIT on which to found its claim, it would probably have been very difficult for Repsol to secure any compensation whatsoever.

As noted above, 57 percent of 274 cases have been decided in favour of the plaintiff company or resulted in a settlement. Thus there are 156 cases in which a state, wholly or partially, had manifestly failed to abide by its obligations not to expropriate without compensation, or to discriminate. In all likelihood, the number of actual cases of discrimination or absent/inadequate compensation in seizure cases and the like is much higher. Bilateral investment treaties, with or without reference to ISDS, thus seem to be a necessary (if insufficient) disincentive to states with shaky traditions of legal certainty. Since the ISDS instrument involves a minimum of state involvement, it improves companies' practical ability to assert their rights. If a company first has to convince its own state to initiate legal proceedings against the host state, obviously the likelihood of a complaint having any effect is drastically reduced. As a rule, states are very much disinclined to create conflicts with other states. The possibilities of being compensated for a violation of an investment protection treaty are thus also drastically reduced. Standing outside ISDS in the future, then, is not, on the whole, in the interests of companies.

Why do we need investment protection regulations with ISDS relative to the US?

b. The significance of ISDS in TTIP

For Swedish companies, the US is currently in a class of its own as the largest investment market, with investment assets totalling 425 billion kronor in 2012. (Investment assets in China the totalled 50 billion kronor.) The relative importance of the US has increased significantly over time: in 2008, our assets there were worth 341 billion kronor (Finland, which is now in second place among the Nordics, held 347 billion at the time); in 2009, the figure was 358 billion (Finland 324); by 2010 the total had increased to 412 billion (Finland 286). The US is also the biggest investment market for the EU as a whole, with approximately 1.5 trillion euros in assets in 2011. US companies hold approximately equal assets in the EU.

The rule of law prevails in the US, but a future in which it would be partly or wholly hostile to foreign companies cannot be ruled out (cf. the protectionist “Buy American” regulations passed during the financial crisis). In particular, at the state level it cannot be ruled out that political measures might be taken that specifically benefit American companies and thus discriminate against European companies. In such a situation, a European company could certainly bring a suit demanding compensation in an American court, but bear in mind that domestic courts are not necessarily obliged to comply with the US’s international obligations. The American system of juries in civil cases is also a complicating factor. Juries are not made up of people with legal training, and in the view of many often allow themselves to be guided too much by sentiment. This is unlikely to work in favour of a European company. The sheer volume of European investments alone should be reason enough for the EU to seek insurance in the form of an investment protection treaty within the framework of TTIP. (Several Eastern European companies already have BITs with the US.) As already argued under point a., the most effective means of approaching this problem would be to let ISDS be the chosen method of resolving disputes.

Besides the bilateral relationship with the US, we need to consider the external consequences of approving a TTIP agreement that does not include investment protection regulations, or in any case does not include ISDS. The EU is currently negotiating an investment protection treaty with China. Regardless of whether the EU establishes a BIT with the US or not, China will presumably be willing to establish a BIT with us – Chinese companies are increasingly active as international investors and are going to have a growing need of protection. The salient point is ISDS. If we can’t pass ISDS with the US, it’s less likely that China will approve ISDS in a treaty with the EU. Given that situation, and the fact that China is not the only rising economy the EU will have to deal with in the future, it is of great strategic importance to Swedish companies that ISDS should become part of TTIP.

Which changes would be possible to make to the current system to allay fears about ISDS?

c. What adjustments of the current ISDS regulations are acceptable to the Confederation of Swedish Enterprise?

Unless an investment protection section is included, it is very unlikely the US would go along with an agreement at all. We therefore assume that any TTIP agreement will include one. Since the dispute resolution component is essential to companies' ability to bring their own cases, we support including ISDS as the solution of choice in TTIP. However, the current version of ISDS has been subject to a variety of criticisms. We can imagine a number of measures that could be taken to assuage the concerns expressed. On the other hand, there are several proposals we do not consider worth pursuing – they would simply render the instrument toothless.

Criticisms of ISDS for the most part are based on the idea that ISDS will affect the ability of states to legislate, and that ISDS would thus represent a threat to their ability to take measures to protect the well-being of humans and animals, and of the environment more generally. It would cause 'regulatory chill': due to their fear of being liable for damages in ISDS cases, states would be reluctant to pass legislation. The argument is almost, but not completely, groundless. Some countries are in the process of withdrawing from BITs for this stated reason, i.e. Indonesia and South Africa. It has also been claimed that the arbitration process itself is not transparent, and that outside interests are not taken into account. (Some believe that ISDS can be exploited to force privatisations of public sector operations. There are claims that ISDS would make it possible for companies to sue a state because they have failed to make a profit. Both of these claims, as will be shown below, are groundless.) Regardless of the factual grounds in cases where a plaintiff company has received or may be entitled to compensation from a host state, states always have the right to legislate. This is also the case under a BIT. However, states' rights to legislate may be constrained by a BIT insofar as the legislation

- Must not involve expropriation (direct or indirect) – without prompt, relevant compensation – of the property of companies from the other state.
- Must not involve discriminatory treatment of companies from the other state.
- Must not be obviously disproportionate.
- Must not involve significant changes to companies' property rights without good reason. If a state behaves contrarywise, the consequence may be that it will end up paying damages to the injured company. However, the state can never be forced to change its legislation. Damages paid to date as a result of settlements under ISDS have on average come in at about 10 percent of the requested amount.

It is in the nature of signing a BIT that a state doing so gives up a small amount of sovereignty. States also do this when they ratify international agreements. Membership in the UN, the Council of Europe or the EU also entails voluntarily ceding a degree of sovereignty. This applies to all international agreements, from the Kyoto Protocol on emission reductions to the European Convention on Human Rights. On the other hand, a state always has the right to legislate questions of public policy doctrine (ordre public), i.e. national security, general social order and safety, the health of humans and animals, and the environment in general. In recent years, new BITs have been expanding and defining more precisely the areas in which a state is always sovereign. The agreement that has come furthest in this respect is the EU's (as yet unratified) agreement with Canada, CETA.

Our basic position is that:

a. Companies or private individuals should not be given the power to change or limit the state's right to legislate through a dispute resolution process such as ISDS,

b. If legislation directly or indirectly strips a company or private individual of its property rights, quick, relevant, non-discriminatory compensation must be provided,

c. The dispute resolution procedure must be as quick and transparent as possible, and independent of state involvement.

A number of elements could be added to ISDS to address the criticisms directed at it. The following list is not intended to be exhaustive – other measures would be quite possible. Nor is it ordered in terms of the individual measures' importance, but rather it is based on the chronological order of dispute resolution processes.

1. Preamble.

Every international agreement has an introductory section, the preamble, with 'having regard to' clauses in which the parties explain their objectives in entering into the agreement in general terms. In international arbitration, the arbitration panel looks to the preamble if there are difficulties of interpretation. In such a situation, the preamble can provide guidance. A preamble in TTIP regarding BITs should be clearer than is currently common about indicating the parties' intentions not to limit legislative options as regards the environment, health and safety.

2. Clear definitions.

The agreement could (as in CETA) describe more precisely what is actually meant by certain common concepts in BITs, such as non-discrimination, fair and equitable treatment, indirect expropriation and compensation.

3. General exceptions.

The agreement could include a list of general exceptions, such as those pertaining to public policy doctrine (ordre public) in GATT articles XX (General Exceptions) and XIV (Exceptions to the Rule of Non-discrimination). In principle, exceptions could apply to any political area at all.

4. Decision clause.

The agreement could include a regulation stipulating that a plaintiff company must choose between domestic legal remedies (i.e. in the host state) and ISDS or some other international procedure to prevent a situation in which two or more legal processes are running concurrently on the same issue.

5. Regulation of nuisance suits.

The agreement could include a clause that filters out obviously groundless claims (as in CETA), combined with a regulation requiring companies to pay the counterparty's (the host state's) expenses in such cases.

6. Compulsory mediation before going to ISDS.

The agreement could stipulate that a company must undertake consultations with its host state and/or home state or submit to a mediation process before going to an arbitration panel. This could be combined with regulations requiring a 'cooling off period', during which it would not be permitted to make a motion for arbitration.

7. Clearer definitions of which investments are protected.

In principle, this should be uncontroversial, but in practice it could have major consequences. The EU's negotiators thus need to take great care to prevent companies from losing rights in the future.

8. Special exceptions.

The agreement could include specifically defined exceptions covering areas such as the public sector in general, financial services, taxes or companies in the defence sector. Here, too, it is important to employ stringent definitions.

9. No 'umbrella clause'.

BITs sometimes include 'umbrella clauses' which fold breaches of ordinary civil contracts (ordinary business agreements) into the investment protection instrument. These may entitle a company to bring the state before an arbitration panel rather than suing it for breach of contract in a domestic court. This possibility does not need to be included.

10. Transparency.

The agreement might, for example, stipulate that UNCITRAL's[5] new transparency rules be included in TTIP. These include requirements that information on the dispute, the parties involved and the names of the arbitration board must be published, and that the economic area in question and the treaty under which the complaint is raised must be identified. Except in cases where state or corporate secrets must be protected, the oral arguments and presentation of evidence must be public.

11. Opportunity for outside parties to present comments.

In some legal systems, there is an opportunity provided for outside parties who can be considered to have an interest in a dispute to introduce comments through an amicus curiae brief. (In the WTO, for example, member states can submit comments on current disputes which do not directly affect them.) The agreement might, for example, grant environmental organisations or business organisations the right to follow a dispute and submit comments.

12. Code of conduct for arbitrators.

The agreement could include such a code.

There are also a number of proposed measures which we oppose. We list a few of them and why we oppose them below.

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[5] United Nations Conference on International Trade Law.

1. Exhaustion of domestic legal remedies.

The agreement could include a regulation requiring a plaintiff company to have first gone through all domestic legal institutions in the host country and lost before being entitled to bring a case using the ISDS instrument.

Our position: **NO**. This would significantly increase companies' costs with no obvious benefit. In practice, a state with an unsatisfactory level of legal certainty could make sure no decision ever came out of its highest court. Even if a clause on unreasonable delay were added, the ISDS instrument would be neutralised in practice.

2. The states establishing an agreement could agree that only both of them jointly could make binding judgements on the contents of the agreement.

There are both pluses and minuses to this idea. One of the minuses is that it would increase the level of politicisation of disputes.

Our position: **NO**. Besides the problem of repoliticising the entire process, this might enable the states to alter the meaning of the agreement after the fact.

3. A special court could be established to handle ISDS cases.

This solution is theoretically possible, but would probably be enormously expensive even to institute, which brings the cost issue into the picture. The problem of potential politicisation also still remains.

Our position: **NO – NOT NOW, BUT MAYBE LATER**. We should try to come to a mutual understanding with the US, not make demands that will make it impossible to establish any agreement at all. With appropriate modifications of the ISDS instrument, it should be possible to deal with all reasonable reservations. A TTIP agreement could include language to the effect that, in the future, the parties will explore the possibilities of a mutually institutionalised ISDS procedure. Having a court would also raise the issue of whether it would be possible to appeal against a decision. One can easily see that a process involving multiple court instances would be colossally time- and cost-intensive. This aspect of ISDS should therefore first be studied carefully.

4. Each party covers its own legal costs today – should this be changed?

Today, both parties cover their own costs, regardless of the outcome of the case. The risk of having to cover the respondent state's legal costs in the event of losing an arbitration case would presumably constitute a powerful barrier to nuisance suits and 'long shots'. The EU's agreement with Canada stipulates that the losing party must bear the counterparty's costs. This is a step too far. It would have been enough to allow an obviously groundless case to lead to such a consequence.

Our position: **NO**. There are already so many barriers built in that private individuals and small and medium-sized enterprises are already operating under a serious handicap. The risk of having to cover the respondent state's costs (which it can inflate to astronomical levels) would simply make ISDS irrelevant to them. Very large companies are relatively insensitive to potential court costs in such contexts. If they elect to make use of ISDS, they probably already believe that they have had to suffer such large losses that the possibility of having to pay the respondent state's court costs would scarcely be relevant.

www.svensktnaringsliv.se
Storgatan 19, 114 82 Stockholm
Telephone +46 8 553 430 00