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## CHAPTER 4. INVESTMENT PROTECTION AND INVESTOR-STATE DISPUTE SETTLEMENT IN THE TTIP

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### **Overview**

The negotiations over the TTIP have caused intensive political discussions and raised concerns from civil society. However, even though several regulatory issues that are envisaged to be part of the TTIP are subjects of the debate, one topic is dominating: ISDS. Indeed, the entire global ISDS system that has been in place for several decades is already in question because of the debate that started with the TTIP. Unfortunately, however, the heated discussion on the TTIP and ISDS is in large part not fact-oriented. The underlying rationale of ISDS and its basic structure are unknown to many participants in the discussion.

The aim of this short essay on ISDS in the TTIP is not to reject or promote ISDS in a political sense. Instead, this contribution tries to lay out some facts on ISDS in order to bring the entire discussion on investor-state dispute settlement back to solid and objective ground. In order to do so, this contribution will first make some brief historical and systemic remarks. Second, this paper will discuss the four topics identified by the European Commission as being most critical: the protection of the right to regulate; the establishment and functioning of arbitral tribunals; the relationship between domestic judicial systems and ISDS; and the establishment of an appeal mechanism and/or an international investment court. Finally, this contribution will make some brief comments on why ISDS also makes sense with regard to trade and investment relations with Canada and the United States.

### **Systemic and historical background of ISDS**

In order to understand the system of international investment protection, it is important to clarify the legal relationship between the foreign investor and the host state of the respective investment. The foreign investor can have a direct legal relationship with the host state. A classical example in this regard is a concession granted by the host state to the foreign investor, for instance, a concession for the exploitation of a natural resource. Such a direct legal relationship between the foreign

investor and the host state is based either on a legal decision by the respective government or on a contractual basis between the investor and the government. It is common to refer to a “contract” in order to specify any such direct legal relationship between a foreign investor and a host state. The problem with this legal relationship is that in almost all cases it is governed by the domestic law of the host state. As any state is — as an expression of its sovereignty — free to change its domestic law at any time, the host state may at any given time modify its domestic law in a way that nullifies or impairs the legal rights granted to the investor. In a situation in which the investor is insufficiently protected by the respective domestic constitution, the investor cannot challenge the sovereign decision of the host state to change its domestic legal system. Public international law does not provide effective protection to the foreign investor. Moreover, even if the respective rules of public international law would be applicable, it is still within the sovereign discretion of the host state how to implement such public international law in the domestic legal system. Thus, there is no guarantee that the respective international law will actually be applicable to a foreign investor.

The only way to ensure effective legal protection of foreign investors is to have a public international law treaty in force between the home state of the investor and the respective host state of the investment. Such a treaty restricts the state sovereignty of the host state and thus, *per definitionem*, prevents unilateral changes to the domestic legal system of the host state to the detriment of the foreign investor. This is the basic idea of so-called bilateral investment treaties, as well as investment protection chapters in free trade agreements.

As already indicated, it is not only the substantive legal protection of the rights of the investor that is of interest here. It is most important to procedurally enforce the rights granted by public international law. A classical instrument in this regard is diplomatic protection by the home state of the investor. However, diplomatic protection is only available if there is a breach of public international law by the host state. As already indicated, the contractual rights of the investor are not usually protected by public international law and are thus not subject to any action of diplomatic protection by the home state. Moreover, there is no right of the investor to diplomatic protection. It is within the political discretion of the home state whether and how to grant diplomatic protection. Thus, diplomatic protection is more a political instrument than a legal right.

Domestic legal remedies within the host state of the investment are also no alternative for the foreign investor. In most states around the world, domestic judicial systems are weak or at least rather ineffective. Most unfortunately, corruption is also an issue in many domestic legal systems. Overall, long-standing experience demonstrates that seeking domestic legal remedies in the host state is time-consuming, costly and ineffective for a foreign investor.

Furthermore, it is important to realise that investors are usually judicial persons. Different to natural persons (individuals), judicial (legal) persons do not enjoy the protection of international human rights. As the Inter-American Commission on Human Rights stated in a report in 1999: “The Commission [...] considers that the Convention grants its protection to physical or natural persons. However, it excludes from its scope legal or

artificial persons, since they represent a legal fiction.”<sup>1</sup> This statement is true for public international law in general. The only exception in this regard is the European Convention on Human Rights. Moreover, even if national constitutions grant human rights to judicial persons, this is usually restricted to domestic judicial persons. A good example in this regard is Article 19 (3) of the German Constitution, which reads as follows: “The basic rights shall also apply to domestic artificial persons to the extent that the nature of such rights permits”.

Because of insufficient legal protection of foreign investors under public international law and most domestic legal systems, the worldwide system of investment protection treaties has been developed. Germany and Pakistan concluded the first investment treaty on November 25<sup>th</sup> 1959 based, among others, on the experience of the Anglo-Iranian Oil Company case before the International Court of Justice (ICJ) of 1952, which demonstrated the insufficient legal protection of contractual rights of investors under public international law. This treaty did not include ISDS; rather, it was restricted to state-to-state dispute settlement. ISDS provisions only emerged at the end of the 1960s. Comprehensive ISDS clauses became common in investment treaties by the end of the 1980s, followed by an increase in arbitral proceedings in the 1990s. After the year 2000, states started to modify their approach towards investment treaties by including sustainability and public interest provisions in treaty language. Since 2000, there has also been an increase in the conclusion of deep and comprehensive free trade agreements containing investment chapters.

Overall, today there are more than 3000 bilateral investment treaties or other international investment agreements (IIAs). In addition, about 600 publicly known international investment disputes have been settled or are still pending. The most frequent respondent state is still Argentina. This is due to the very specific circumstances surrounding the Argentinian financial crisis of 2002. Other frequent respondent states are Venezuela, the Czech Republic, Egypt, Canada, Mexico, Ecuador, India, Ukraine, Poland and the United States. As to home states of those investors bringing ISDS cases, most claimants come from the European Union, followed by investors from the United States.

## Central issues in the TTIP debate

The TTIP's proposed investment protection standards and dispute settlement mechanism have raised concerns from governments, private industry and civil society. The intensive political debate on this has led the European Commission to initiate a public consultation on investment protection in the TTIP. The commission received more than 150,000 replies to its public consultation. However, a large majority of these replies were automatically generated by electronic means and thus not of much substantial value. Nevertheless, the commission identified four areas that are most important in the current discussion: (1) the protection of the right to regulate; (2) the establishment and functioning of arbitral tribunals; (3) the relationship between domestic judicial systems and ISDS; and, (4) the review of ISDS decisions through an appellate mechanism, and – as a further development in the discussion and closely related – the establishment of an international investment court.<sup>2</sup>

1. Bendeck-Cohdinsa v. Honduras, Report N° 106/99, OEA/Ser.L/V/II.106 Doc. 3 rev. at 311 (1999), para. 17.
2. The following parts of this essay are based on: Freya Baetens/Christian Tietje, “The Impact of ISDS in the Transatlantic Trade and Investment Partnership”, a study prepared for Minister for Foreign Trade and Development. Cooperation, Ministry of Foreign Affairs, The Netherlands, June 2015, available at: <http://www.rijksoverheid.nl/documenten-en-publicaties/rapporten/2014/06/24/the-impact-of-investor-state-dispute-settlement-isd-in-the-ttip.html>

## The right to regulate

A major concern for civil society is whether investment protection might restrict the sovereign right of a state to regulate. However, there is no empirical evidence for the theory that investment protection and/or arbitration has caused states to withdraw or refuse to enact regulations aimed at legitimate policy concerns. On the contrary, even though “regulatory chill” is by its very nature hard to prove, there are strong indications that investment protection and arbitration have no or only limited impact on the legislative autonomy of states. This is due to the following facts: First, the vast majority of ISDS claims challenge administrative decisions affecting single investors rather than legislative or regulatory acts per se. Second, it is difficult to make a case that ISDS is, or has ever been, the sole cause in preventing progressive regulation, especially given that regulations which impact on areas like the environment and natural resources usually involve continuous policy debates. Third, a close look at modern BITs and other International Investment Agreements (IIAs) as well as the study of the practice of arbitral tribunals clearly indicate that a “right to regulate” is well established as part of the substantive definitions, general exception clauses and preamble language in contemporary international investment protection law. This approach is clearly evidenced in CETA—the draft Comprehensive Economic and Trade Agreement between the EU and Canada. CETA strikes a good balance in promoting progressive policy changes while respecting investors’ rights. Making states’ rights to regulate more explicit in CETA (and the TTIP) with regard to certain legitimate public policy concerns provides clear guidance for arbitral tribunals, ensures that investors will not make investment decisions based on unfounded expectations, and prevents the abolishment of the entire system of investment protection.

These conclusions are strongly supported by an analysis of the dispute settlement practice under NAFTA and the Central American Free Trade Agreement (CAFTA). Claimants that succeed in ISDS in NAFTA have not directly challenged any government’s authority or ability to regulate within a given policy space. Instead, the large majority of NAFTA and CAFTA cases involve individual contractual, tax, or export control issues. Indeed, investor claims that directly challenge government regulations, and thus the government’s policy space, have never succeeded.

## The establishment and functioning of arbitral tribunals

Concerns have been raised as to the impartiality of arbitral tribunals and arbitrators. Even though it is questionable whether there is really any problem in this regard in the current systems, again, CETA, as the blueprint for the TTIP, includes innovative elements. CETA provides, inter alia, for the adoption of a code of conduct of arbitrators addressing conflicts of interest and ethics as well as the establishment of a roster of arbitrators, who are pre-selected by the states (EU).

However, some caution is necessary. There is already long-standing experience in international dispute settlement with rosters of arbitrators. Taking the example of the list of arbitrators of the Permanent Court

of Arbitration (PCA) indicates that several persons on this list were not nominated because of any relevant expertise in dispute settlement, but for other, political reasons.

Despite any political debate on the TTIP, there is consensus that transparency in ISDS needs to be improved. The UNCITRAL Rules on Transparency in Treaty-based Investor-State Arbitration (effective date: April 1<sup>st</sup> 2014) and the Convention on Transparency in Treaty-based Investor-State Arbitration (“Transparency Convention”), adopted by the UN General Assembly on December 10<sup>th</sup> 2014 but not yet in force, provide clear guidelines in this regard.

## **The relationship between domestic judicial systems and ISDS**

A further issue in the current debate on ISDS concerns the relationship between domestic judicial systems and international dispute settlement. Most prominent in this regard is the call for a requirement of the exhaustion of local remedies before initiating international arbitral proceedings. In the current ISDS system in force, it is not common to require the exhaustion of local remedies. On the contrary, the modern ISDS system was created precisely in order to overcome the requirement to exhaust local remedies as a prerequisite of the classical legal instrument of diplomatic protection.

If the rule of exhaustion of local remedies were to be included in the TTIP or any other ISDS system, international arbitration would function in effect as a second-level remedy—an “appeal” at an international level after domestic redress has been sought. This would have the potential to cause conflicts between the domestic and the international judicial systems. Moreover, introducing such a second-level remedy would result in significant delays and in additional costs for both the investor and the state.

A more favourable alternative would be to provide for a fork in the road provision. This would require the investor to choose between bringing their claim before the host state’s courts or an international tribunal, with such a choice being irreversible. The advantage of this system is to avoid contradictory results and to confine the investor to one remedy by forestalling recourse to others. Moreover, this option does not entail extra costs and time, while, most importantly, it prevents foreign investors from having a wider range of *fora* available to pursue a claim than domestic investors.

An intermediate option could be, first, to require parties to seek redress in local courts, and, second, to allow for international proceedings only if no satisfactory remedy is granted after a defined period of time (e.g. 2 years).

### Appeal mechanism and a possible International Investment Court

Most prominent in the current debate on ISDS and the TTIP is the call for an appeal mechanism and the establishment of some kind of public court system for investment disputes. The EU Parliament summarised this

discussion in its resolution of 8 July 2015 on the TTIP.<sup>3</sup> The relevant section of this resolution reads as follows (p. 15 et seq.):

*“... to ensure that foreign investors are treated in a non-discriminatory fashion, while benefiting from no greater rights than domestic investors, and to replace the ISDS system with a new system for resolving disputes between investors and states which is subject to democratic principles and scrutiny, where potential cases are treated in a transparent manner by publicly appointed, independent professional judges in public hearings and which includes an appellate mechanism, where consistency of judicial decisions is ensured, the jurisdiction of courts of the EU and of the Member States is respected, and where private interests cannot undermine public policy objectives”.*

It is obvious that the EU Parliament, like large parts of civil society, is of the opinion that the current ISDS system is characterised by “private” arbitration/dispute settlement and that this ought to be replaced by a “public” international court system. This assumption is not correct. ISDS based on an arbitration clause in a BIT or in a free trade agreement has its legal basis in public international law. Moreover, domestic parliaments have given their consent to any such arbitration by approving ratification of the respective treaty. ISDS is, of course, already a means of public dispute settlement.

Even though the establishment of a possible international investment court, including some kind of appeal mechanism, within the framework of CETA or the TTIP or even on a broader scale sounds appealing, some fundamental problems and challenges must be highlighted:

Regarding a possible appeal mechanism, the experience with the WTO Appellate Body is instructive. In this regard, the selection of members of the Appellate Body has proven to be complicated, namely with regard to limited remuneration/salary and sufficient qualification. Indeed, experience not only with the WTO Appellate Body, but also with any international court demonstrates that financing the system by states/the EU is always a problem. States are constantly unwilling to provide the sufficient financial resources needed for the effective functioning of the institution.

The risk exists that as soon as an appeal mechanism is available, the losing party might be pressured by its citizens (in the case of states) or its shareholders (in the case of companies) to appeal the decision, regardless of the chances of success. Again, the WTO experience shows that this was certainly the case, at least at the beginning of the Appellate Body’s existence. In addition, when discussing a possible ISDS appeal mechanism in the TTIP, one should be aware that any appeal institution might become a de facto lawmaker as its decisions would have influential effects as precedents.

Moreover, international arbitration, including ISDS, is always subject to domestic court review and supervision. Domestic courts have certain competences to intervene in pending arbitral proceedings according to the *lex arbitri* principles. Furthermore, international arbitral awards are always subject to recognition and enforcement by domestic courts

3. European Parliament resolution of 8 July 2015 containing the European Parliament’s recommendations to the European Commission on the negotiations for the Transatlantic Trade and Investment Partnership (TTIP) (2014/2228 (INI)).



in accordance with the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958. The New York Convention stipulates the obligation to recognise and enforce international arbitral awards subject to the so-called *ordre public*. Art. V(2) of the convention reads as follows: "Recognition and enforcement of an arbitral award may also be refused if the competent authority in the country where recognition and enforcement is sought finds that:(b) The recognition or enforcement of the award would be contrary to the public policy of that country."

The only exception in this regard is the procedure according to the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID). ICSID proceedings do not have the hybrid character of interplay between national and international law as do other arbitral proceedings, but are exclusively rooted in public international law. Thus, there is no domestic *lex arbitri* in ICSID proceedings. In addition, ICSID awards are as enforceable as domestic court judgements. Hence, the New York Convention of 1958 is not applicable. However, ICSID proceedings against the EU will not be possible as the EU is not entitled to become a party to the ICSID convention. Only states may ratify the convention.

The ECJ has made clear that arbitration as such is compatible with the legal order of the EU. However, domestic courts are obliged to ensure compliance with EU law if they are to deal with arbitration because of *lex arbitri*, or with regard to the recognition and enforcement of arbitral awards. Thus, in the case that an international arbitral award is in contradiction with basic principles of EU law (such as the fundamental freedoms or EU competition law), a domestic court of an EU member state must refuse the recognition and/or enforcement of such an award because of a violation of the European *ordre public* (Art. V(2)(b) New York Convention 1958).<sup>4</sup>

Establishing an international investment court would de facto require that the judgments of such a court (or appellate institution) be directly enforceable in domestic legal orders. It would certainly be possible to make respective court proceedings subject to domestic *lex arbitri* and/or the New York Convention of 1958. However, any such attempt would seriously undermine the authority of a respective international court. Thus, only a provision as provided for in the Unified Agreement for the Investment of Arab Capital in the Arab States of November 26<sup>th</sup> 1980 is realistic. This agreement, which has been ratified by most member states of the Arab League and which entered into force on September 7<sup>th</sup> 1981, provides for the establishment of a regional court for investment disputes. Art. 34 of the Agreement stipulates that "(1) [j]udgements shall have binding force ..., (2) [j]udgements shall be final and not subject to appeal ..., (3) [a] judgement delivered by the Court shall be enforceable in the State Parties, where they shall be immediately enforceable in the same manner as a final enforceable judgment delivered by their own competent courts."

Overall, abolishing investment arbitration and establishing an international investment court is certainly possible. However, it might be that states (and the EU) would lose more than they would gain from such a step.

4. ECJ, Case C-126/97, *Eco Swiss* [1999].

## Why ISDS with Canada and the USA?

A point that is constantly raised in the current debate on the TTIP and investment protection is that investment protection and, specifically, ISDS are only necessary (if at all) in relation to “weak” states. The USA (and Canada), however, are states under the rule of law. Two aspects should be considered with regard to this argument. First, there are long standing conflicts with the US on the functioning of their judicial system (keywords in this regard are, i.a.: jury system; discovery vs. data protection; “exorbitant” or “extraterritorial” jurisdiction; class action and punitive and triple damages). The German Federal Constitutional Court in a decision of 25 July 2003 (2 BvR 1198/03) even made clear that certain aspects of the US system of class action and punitive damages are contrary to fundamental principles of German constitutional law. It is thus certainly not evident that the US legal system is equivalent to the rule of law idea in the European sense.

Moreover, second, international arbitral practice clearly demonstrates that foreign investors may be treated in the US in a sense that raises concerns. In the case of *Loewen vs. USA* (NAFTA Award of June 26<sup>th</sup> 2003), the tribunal described the treatment of the Canadian investor in the US in the following words: “By any standard of measurement, the trial involving O’Keefe and Loewen was a disgrace. By any standard of review, the tactics of O’Keefe’s lawyers, particularly Mr. Gary, were impermissible. By any standard of evaluation, the trial judge failed to afford Loewen the process that was due.” Similar issues are raised in the case of *Mondev vs. USA* (NAFTA, 2002).

Finally, the political dimension of including ISDS and investment protection in a trade agreement with the US is important. It is obvious that whatever is negotiated between the US and the EU will have significant impact on any future trade and investment negotiations around the world. The TTIP will be a blueprint for trade and investment lawmaking to come. There is thus a serious risk of globally abolishing investment protection for all. This will most certainly have a negative impact on the worldwide flow of foreign investment.

## Conclusion

This short essay has highlighted some important aspects explaining the rationale of international investment protection and ISDS. The substantive and procedural law of international investment protection is an important part of the global rule of law. As with any public international law, international investment protection law restricts state sovereignty. This is the very idea of public international law. However, any such restriction is part of a balanced system of rights and exceptions. As the Tribunal in *Semire vs. Ukraine* stated:

*“The object and purpose of the Treaty is not to protect foreign investments per se, but as an aid to the development of the domestic economy. And local development requires that the preferential treatment of foreigners be balanced against the legitimate right of Ukraine to pass legislation and adopt measures for the protection of what as a sovereign it perceives to be its public interest.”<sup>5</sup>*

5. *Semire vs. Ukraine*, ICSID Case NO. ARB/06/18, Decision on Jurisdiction and Liability, 14 January 2010, para. 273.

This approach is common practice and increasingly reflected in explicit treaty language. However, this does not mean that there is no space and necessity for improvement of the system. Transparency and more precise treaty language are examples. The TTIP (and CETA) should be seen as a chance for a global model of such improvements.

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