SUBMISSION TO THE PRODUCTIVITY COMMISSION

BILATERAL AND REGIONAL TRADE AGREEMENTS STUDY

DATE: 23 September 2010

SUBMISSION TO: Review of Bilateral and Regional Trade Agreements, Productivity Commission, GPO Box 1428, Canberra City ACT 2601**,** Fax: Jill Irvine, 02 6240 3311, Email: tradeagreements@pc.gov.au

SUBMISSION FROM: Gus Van Harten, Associate Professor, Osgoode Hall Law School, Toronto, Canada, 416 650 8419, gvanharten@osgoode.yorku.ca, Publications: http://ssrn.com/author=638855

I learned recently of the public submissions process for this Productivity Commission study. While the deadline for submissions has passed, I hope the following may still be of use.

The thrust of this submission is that investor-state arbitation is a legal mechanism originally designed to discipline newly-independent countries or countries that lacked mature institutions of government, especially in the judicial branch. It is however wholly unsuited to the final review of public decision-making in the modern regulatory state and to the replacement of courts as an independent branch of government, especially in public law. There have unfortunately been efforts by persons and organizations with direct interests in the maintenance and expansion of investor-state arbitration to advocate for its inclusion in trade and investment agreements based on unsubstantiated assertions about its benefits and an under-statement of its regulatory and economic costs. It is thus in my view welcome and positive for the Productivity Council to take an independent and careful look at perspectives in the debate.

I have three specific comments arising from pages 13.17 through 13.20 of the draft study.

- *reference on page 13.20 to the fact that cases are not appellable and that there is no system of precedent in investor-state arbitration.*

These are indeed important factors in undermining the coherence and predictability of the rules and principles of investor protection, although the absence of a heirarchical judicial structure is, in my view, more significant in this respect than the absence of a system of precedent. Consider for instance that civil and international law rely on the persuasive, as opposed to strictly precedential, effect of past cases, and that any system of precedent must still work out whether a past precedent should be distinguished.

More important, I suggest, is that the rules and principles employed in investor-state arbitration are usually vague (e.g. “fair and equitable treatment”), have been interpreted by tribunals to create an objective standard of liability for states (i.e. without any requirement of an intent to harm or fault on the part of the state; e.g. *CMS v Argentina*), and yet they are accompanied by an extraordinarily powerful and retrospective remedy: international enforceable damages awards against the state for its public law acts, including legislative, judicial and general policy decisions. Alongside this remedy is the exceptional removal of any duty of the investor to resort to reasonably available local remedies and thus of the conventional mediator between domestic decision-making and the international tribunal. In the context of the EU law, the *Francovich* doctrine – by which individuals may be awarded damages against an EU member state where the state has breached an EC legal obligation and harmed the individual – was moderated shortly after its invention by the European Court of Justice to specify, among other things, that only "sufficiently serious" breaches by the state would justify state liability. No similar express limit has been adopted by any investment tribunal, even though the investment treaty disciplines are more direct and acute because of the absence of the duty to resort to local remedies. (Note in the context of the *Francovich* doctrine in EU law, and indeed in all other contexts where individuals may bring a treaty claim directly against a state for its regulatory acts, there is such a duty.) As a result, states such as Argentina have faced catastrophic damages awards after being found, years after the fact, to have violated vague principles that have been subject to conflicting interpretations by tribunals. This is a serious concern for regulators and taxpayers, and it throws into relief the inappropriateness of assigning to arbitrators, as opposed to judges protected by institutional safeguards of independence, the power to resolve finally the meaning of high-end public law concepts.

- *reference on page 13.20 to the fact that U.S. investors have never lost a case.*

This is inaccurate – there are numerous cases in which U.S. claimants have been unsuccessful. What is accurate, however, is that the U.S. government has never lost a claim against it by a foreign investor (as it happens, all have been by Canadian investors under NAFTA). Some of these cases were based on notably restrictive interpretations of key concepts (national treatment in *ADF v USA*, effective duty to resort to resort to local remedies in *Loewen v USA*, continuous foreign nationality in *Loewen v USA*, fair and equitable treatment in *Glamis Gold v USA*, expropriation and national treatment in *Methanex v USA*). While I tend to support the interpretations offered in these cases, it has struck me when teaching investment law to students how so many of the examples of the "restrictive" approach tend to involve cases against the United States. Along the same lines, a finding by McArthur and Ormachea (2009) – which the authors described as "remarkable" – is that U.S. investors (who had brought 29 of the 74 cases reviewed) were 40% less likely to see their claims rejected at the jurisdictional stage than investors of other nationalities (10% rejection rate for U.S. investors, compared to 16.92% for other nationalities). Of course, there is clearly insufficient data in either case to draw general conclusions about the performance of arbitrators in cases against the U.S. or involving U.S. claimants. As I discuss below, the more appropriate focus is on adequate safeguards of independence in the adjudicative process rather than proof or dis-proof of actual bias.

- *reference on page 13.20 to the need for a robust dispute settlement mechanism, especially where the domestic legal system is not sufficiently developed, and advice that such dispute settlement should not afford foreign investors with privileged substantive or procedural treatment relative to local investors.*

I applaud the Council for recognizing the need to preserve a level playing field among domestic and foreign investors while at the same time seeking appropriately targeted protections for investors. There has been an unfortunate tendency in the debate to leap to the conclusion that, because the legal systems of some states are undeveloped, it is unfair to require foreign investors to resort to domestic remedies in all countries and in all cases. A more appropriate response would be to remove the duty to exhaust to local remedies only where such remedies are shown by the investor not to be reasonably available, or to offer the host state at least the opportunity to demonstrate that its legal remedies, both generally and specifically, were reasonably available to the investor.

It is moreover inappropriate to replace domestic legal systems that are open to perceived bias against foreign investors with international mechanisms that are open to a perceived bias against those states (or their investors) who do not wield influence in the investment arbitration industry or relevant appointing authorities. The appropriate substitute for undeveloped domestic courts is a well-developed international judicial body, although suggestions for the latter have been resisted, at least in public discourse, by many in the investment arbitration industry.

At the very least, resort to investor-state arbitration to resolve investor-state disputes in matters of regulatory decision-making should be based on institutional safeguards against bias or other inappropriate conduct by the adjudicator. This should include: openness of the proceedings as a governing principle, designation by states of a roster of persons who are eligible for a set period to sit as arbitrators (whether appointed by the investor, state, or outside appointing authority), bars on the earning of significant income from investor-state litigation where a person is or has been on the roster, express and mandatory bars against personal conflicts of interest, an objective method for the selection of arbitrators for appointment by the outside appointing authority, control by an independent body of the rules of procedure, mechanisms to provide legal standing to parties other than the claimant and state whose interests are significantly affected by the dispute, and an independent judicial process to resolve conflict of interest claims. All of these checks are currently missing or lacking in the case of investor-state arbitration.

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The remainder of this submission reproduces comments that I provided in July 2009 to the U.S. State Department Public Hearing on the U.S. Model Bilateral Investment Treaty. It addresses the inclusion of investor-state dispute settlement provisions in BITs and free trade agreements such as NAFTA. While the specifics of the discussion may not apply in all cases to Australian IPPAs and trade agreements, I have included these comments because I believe a fair bit of them may be of use. I have made some slight modifications prior to its submission to you.

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The aim of these remarks is to identify and justify specific BIT reforms to promote an approach to investment protection that (1) encourages foreign investment that contributes to job creation and economic development, while (2) allowing policy space for governments to develop and regulate their economies sustainably and (3) ensuring the equitable governance of investment disputes such that foreign investors are not privileged, procedurally or substantively, over domestic investors and citizens.

<u>The need for BIT reform</u>

Investment protection and regulation for sustainable development

An important role of BITs is to encourage and protect foreign investment in order to create jobs, develop the economy, and support the shift to a green economy. Toward this end, foreign investors are given robust protections, especially by the provision for compulsory arbitration to decide investor claims against governments. In various respects, though, the U.S. model BIT goes too far by favoring investors over other interests, by constraining governmentsm, and by privileging foreign investors.

Foreign investors are protected under the U.S. and other model BITs by broad standards on expropriation, non-discrimination, fair and equitable treatment, and other topics. However, past decisions of some BIT and NAFTA tribunals have interpreted these standards in an overly expansive, pro-investor direction. This calls for clarification that the treaty does not require payment of public compensation to investors whenever they are affected negatively by laws or regulations passed in good faith for a public purpose (Peterson 2004, 28-32; Lawrence 2006, 294-5). Various reforms in the NAFTA context recognize that tribunals have used their discretion to take investment treaties too far in favor of investors (see Appendix A; Thomas 2002; Gaillard 2002, 249; McLachlan 2002, 340; Tollefson 2002, 207-13 and 224-5; Munro 2005; Salgado 2006).

Concerns about regulatory chill

Expansive interpretations of indirect expropriation and other treaty terms are troubling because of their potential to generate ‘regulatory chill’. They enable foreign investors to entangle governments in international litigation and expose them to costly awards, even where the government has acted in good faith in pursuit of a legitimate purpose. In the words of one attorney, the ability to sue under an investment treaty is:

> an open invitation to unhappy investors, tempted to complain that a financial or business failure was due to improper regulation, misguided macroeconomic policy, or discriminatory treatment by the host government and delighted by the opportunity to threaten the national government with a tedious expensive arbitration (Rogers 2000).

Various studies have raised concern about regulatory chill. They have highlighted the risk that BITs and other investment treaties (such as NAFTA Chapter 11) frustrate government efforts to protect health and the environment, preserve natural resources (such as fresh water), counter climate change, promote economic development, regulate utilities and deliver government services, make zoning decisions, reform health care, or regulate the financial sector (Werksman et al. 2001; Shrybman 2001; Flood and Epps 2002; Been and Beauvais 2003; Porterfield 2004; Lawrence 2006; Jenkins 2007; Cumming and Froehlich 2007; Gerbasi and Warner 2007; Shrybman 2008; Mann 2008).

It is difficult, if not impossible, to establish definitively that any particular measure was abandoned as a result of a BIT claim. But it would appear that various measures have been withdrawn in the face of threatened claims. Documented cases include, for example, withdrawn proposals in Canada to require plain packaging of cigarettes, to establish public auto insurance, and to privatize a water filtration plant (Schneiderman 2008, ch 3-4; Carrigg 2001).

Not all investor claims have been successful under BITs of course. But the fact they can be brought with such ease enables firms not only to protect themselves in cases where they have suffered abuse, but also to pressure or harass governments inappropriately and thus to frustrate legitimate initiatives (Cumming and Froehlich 2007, 124). An ongoing NAFTA Chapter 11 claim by Dow AgroSciences against Canada, for example – in response to Quebec's restrictions on cosmetic use of the chemical pesticide 2,4-D – appears aimed as much at deterring other governments from taking similar steps to reduce pesticide use for health and environmental reasons as much as it is meant to win compensation of $2 million, as claimed, for the incidental impact on Dow's sales in Quebec.

The threat to financial, economic, and environmental reform

Under BITs, foreign investors have used investor-state arbitration to bring close to 400 known claims against countries, usually in the developing world. They have challenged a wide range of policies and decisions. Perhaps most ominous are the 46 claims brought against Argentina for its reforms in the face of the country's financial and economic crisis in 2001. These claims have led to hundreds of millions of dollars in awards against Argentina and will likely generate billions more.

Capital-exporting countries like the U.S. and Canada have an interest to ensure protection of assets owned abroad by their nationals, but also to limit their own exposure to claims so as to protect their treasuries and regulatory processes (Cumming and Froehlich 2007, 135). Law firms specializing in investment arbitration drum up business by advising investors on how to bring investor-state claims for losses caused by government reforms in response to the recent global financial crisis,[1] more claims are

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[1] According to a client pamphlet issued recently by a London-based firm (Cameron May 2009):

> States are coming under increasing pressure to take measures to bolster their national economies in response to the global economic downturn. Whist it may be appropriate for States to take measures to address the financial crisis, foreign investors could be entitled to compensation if such measures are taken in breach of the terms of investment treaties…. Since the Argentinean crisis has similarities with the financial difficulties now being encountered around the world, it is instructive to see how claims arising from huge losses suffered at the time are now being resolved….

now emerging against developed states, and the arbitration mechanism puts at risk the regulatory capacity of all countries, with repercussions for issues of global importance including financial regulation, climate change mitigation, and public health protection.

Equitable governance of investment disputes

Investment disputes should be resolved fairly via an independent adjudicative process that is accountable, ultimately, to public decision-makers. Investors may have good cause to seek protection through review, even for apparently legitimate government action. But the investor-state model under the U.S. and other BITs is overly dependent on a small clique of largely unregulated arbitrators in its resolution of vital issues of public policy.

For all investors, foreign or domestic, protection should be provided by the courts. Exceptionally, back-up protection may be required at the international level. But international adjudication should be an exceptional remedy, not one of first resort, and foreign investors should not be able to circumvent domestic courts that offer a forum for justice that is at least as fair and independent as arbitration. In this and other respects, foreign investors must not be unduly privileged over domestic investors and citizens who are also profoundly affected by government decisions, but given no opportunity to seek party standing in the arbitration process.

The privileging of foreign investors over citizens

Investor-state arbitration in its current form under U.S. BITs gives foreign investors the great power to force states to submit the decisions of their legislatures, courts, and agencies to intensive review and discipline by arbitrators, outside of any court process (Gerbasi and Warner 2007, 130). Many disputes that can and should be resolved at the domestic level are brought before international tribunals. The system is especially one-sided in that, while investors can claim public compensation, they are not themselves subject to regulation through the adjudicative process (Yu and Marshall 2008).

The lack of independence of investor-state arbitrators in deciding public policy

The use of arbitration to make final decisions on what are effectively matters of public law and policy – especially where it involves legislative choices or large amounts of public funds – undermines judicial independence in a serious way. Arbitrators are reasonably seen to have an interest to interpret the law in favor of investors so as to encourage future claims and grow the arbitration industry. This apparent bias offers a credible explanation for the surprisingly pro-investor approaches of numerous tribunals (e.g. *Metalclad* 2000; *Pope & Talbot* 2001; *Tecnicas* 2003; *Santa Elena* 2000; *Maffezini* 2000; *CME* 2001; *Siemens* 2004; *Tokios* 2004; *Occidental* 2004; *CMS* 2005). Numerous tribunals have required payment of compensation for a range of non-discriminatory measures where investors have sustained incidental loss as a result of government action taken in good faith and for legitimate purposes. Moreover, tribunals are insulated from review by independent judges, whether domestic or international (Sornarajah 2002; Atik 2004, 221-224; Van Harten 2007, ch 7).

These are fundamental concerns, especially because investment treaties allow for such broad review of legislative and policy decisions.[2] Arbitrators are given authority over government regulators and public funds in ways that go well beyond other treaties (including the WTO) where states have subjected themselves to international adjudication.

This is no one's 'fault', but it should be corrected

The origins of the choice to use international arbitration to resolve investor-state disputes, rather than domestic courts or an international judicial body, date from the 1960s when European countries that pioneered the relevant BITs were concerned to protect assets owned by their firms in former colonies. Where the number of BITs and countries involved was small, the use of arbitration made a degree of sense. Now that investment treaties have expanded to cover thousands of bilateral relationships between states, subjecting a vast array of government activity to discipline within the system, steps need to be taken to ensure that the system is not open to inappropriate bias in favour of private interests. This is a matter of public confidence in the system as well as basic fairness. More states may well refuse to recognize the legitimacy of the system unless it is genuinely insulated from inappropriate influence by private interests. This means moving from the use of arbitration in public law to reliance on institutionalized judicial bodies, whether domestic or international, that have a tenured membership and enjoy other well-known safeguards of their independence.

<u>Overarching principles and goals for reform</u>

The principle of sustainable development

Investment treaties should allow appropriate policy space for governments to take action, free of the risk of a ruinous damages award, to enact laws and regulations on pressing issues so long as the measure in question does not target foreign investors in a specific way for abuse or discrimination. This policy space should be broadest for legislatures and courts, and for policy decisions of the executive. Reforms should aim to establish a regime in which states have appropriate options to regulate in good faith, without risk of international claims and liability.

The principle of equitable governance

To ensure equitable governance, compulsory adjudication under BITs must be protected from inappropriate influence by investors and other private actors. The process should defer to the democratic legitimacy of legislatures, the independence of domestic courts, and the expertise of executive agencies (Weiler 2000, 207-210; Brown 2002, 40-41). Foreign investors should not be allowed to circumvent domestic courts where they offer justice. BIT arbitration itself should offer an independent and fair process, both for the investor and the state, consistent with principles of judging in the traditions of liberal

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[2] Supplemented by the prospect of further review by an ICSID annulment tribunal, or by a domestic court located in the jurisdictional seat of the arbitration, but only on limited grounds not including errors of law or fact.

democratic states and in international law (UN Basic Principles 1985; Mackenzie and Sands 2003; Meron 2005; Van Harten 2008).

Recommended instruments, policies and provisions

Suggested reforms to the model BIT, and their key components, are summarized below. Appendix A elaborates on these proposals in detail, including by identifying other agreements that incorporate or contemplate many of the suggested reforms.

Notably, many recent reforms to U.S. BITs are based on the 'May 10 Agreement' in the U.S. Congress and Administration. This was an important development but, for reasons discussed above, it falls short in significant ways, especially because it does not address (1) the risk that arbitrators will continue to interpret the treaty – however carefully re-worded – in an unduly pro-investor way or (2) the procedural privileges that investor-state arbitration unfairly provides to foreign investors.

The recommended reforms are summarized as follows.

Reform the dispute settlement regime:

- consider removing the investor-state regime outright from U.S. BITs

- as a temporary measure to ensure independence, designate a roster of experts – preferably sitting judges – from which presiding arbitrators (or all arbitrators) must be chosen;

- establish a regional adjudicative body to replace or supplement the role of private arbitration, and to ensure independence and enhance coherence in the decision-making process;

- provide for the members of the regional adjudicative body to develop rules to govern the resolution of investor-state disputes;

- provide for standing in the process for persons or entities whose interests are directly affected by an investor-state dispute, and allow states to bring counter-claims against foreign investors for breaches of their own duties or obligations.

Ensure that international arbitration is an exceptional remedy:

- preclude foreign investors from circumventing domestic courts where the courts offer justice;

- expand BIT screening mechanisms to ensure flexibility and predictability in key fields of regulation, such as financial regulation and health/ environmental protection;

- take steps to limit forum-shopping and 'claims of convenience' by investors from third party states.

Clarify broadly-framed substantive standards:

- limit further the concepts of indirect expropriation and 'fair and equitable treatment';

- clarify that national treatment requires evidence of either (1) intentional discrimination or (2) *de facto* discrimination against foreign investors as a group;

- clarify that most-favored-nation treatment does not defeat exceptions.

Provide exceptions to protect legitimate regulation:

- incorporate more flexible exceptions for measures that aim to safeguard the financial system;

- allow for tailored use of capital controls and performance requirements where justified to maintain financial stability or boost productivity and employment;

- incorporate general exceptions based on GATT Article XX.

Check the discretion of investor-state tribunals:

- direct tribunals to defer to legislative and judicial decisions, and to policy decisions of the executive, where the decision does not target foreign investors for abusive or discriminatory treatment;

- clarify that tribunals should defer to the shared views of the BIT states parties, including where expressed by their governments participating in an investor-state arbitration, regarding the proper interpretation of the treaty;

- clarify that tribunals may award partial damages, or simply a costs award or declaratory award, as adequate satisfaction for a foreign investor, and that any damages award should account for the degree of blameworthiness of the respondent state.

Revise the treaty's statement of objectives:

- revise the BIT's statement of objectives by referring, among other things, to the equitable governance of investment disputes based on judicial openness, independence, and accountability.

Thank you for this opportunity to offer input on the important issues that are at stake in this review process.

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