

Investment Rules in Trade Agreements

Top 10 Changes to Reduce the Threats to the Public Interest

The U.S. government has signed free trade agreements or bilateral investment treaties with 52 nations that provide sweeping powers to private foreign investors and corporations but impose no new social or environmental obligations. As a result, these rules facilitate off-shoring of U.S. jobs and undermine sustainable development strategies. They are also anti-democratic. Private foreign investors are allowed to bypass domestic courts and sue governments in international tribunals, demanding compensation for laws and regulations that reduce the value of their investments.

This document identifies the top 10 changes to these investment rules that would do the most to reduce the threat to the general public and environment. The list begins with the most controversial and problematic element – investor-state dispute settlement. Changes to this mechanism are critical if we are to strike the right balance between public versus private for-profit interests. However, even if this mechanism is left intact, other reforms could go a long way towards reining in the excessive powers granted to private investors.

1. Replace the Investor-State Dispute Settlement Mechanism

The international tribunals that currently rule over investor-state claims lack public accountability, standard judicial ethics rules, and appeals processes. This system should be replaced with a state-to-state mechanism to guarantee the crucial role of governments in protecting the public interest. If this is not possible, investors should at least be required to exhaust domestic remedies before proceeding to international tribunals. A diplomatic screen should also be established to prevent frivolous claims or claims which otherwise may cause serious public harm. See page 3 for more detailed information.

2. Limit Claims over “Minimum Standard of Treatment” to Ensure Compliance with the “No Greater Rights” Principle

Vaguely worded provisions guaranteeing foreign investors a “minimum standard of treatment,” including “fair and equitable treatment,” open the door to investor-state claims over a wide range of government measures that are permissible under the U.S. Constitution. In the case of *Glamis Gold v. The United States*, U.S. State Department lawyers successfully persuaded the tribunal to accept a relatively narrow interpretation of the MST principle. Since these tribunals are not required to follow judicial precedent, these arguments should be codified in treaty text to prevent arbitrators in future cases from making overly broad interpretations that undermine responsible policymaking. See page 5 for more detailed information.

3. Limit Claims over “Indirect Expropriation” to Comply with the “No Greater Rights” Principle

In the past, expropriation applied to the physical taking of property, for example when a government expropriates a house to make way for a highway. Under most international investment agreements today, investors are also protected against “indirect” expropriation, which can be interpreted to mean regulations and other government actions that significantly reduce the value of a foreign investment. While international arbitration tribunals cannot force a government to repeal laws or regulations, the threat of massive damages awards can put a “chilling effect” on policymaking. Treaties should be revised to clarify that regulatory measures that do not transfer ownership of the investment do not constitute acts of indirect expropriation. See page 7 for more detailed information.

4. Narrow the Definition of Investment

Covered investments should include only the real property rights and other specific interests in property that are protected under the U.S. Constitution.

5. Allow Policies to Prevent and Mitigate Financial Crisis

Although many governments have used capital controls effectively to avoid the worst effects of financial crises, U.S. FTAs and BITs still include sweeping restrictions on this policy tool. Existing rules could also

thwart efforts to adopt small taxes on foreign exchange transactions and trades of other financial instruments aimed at curbing excessive speculation. Agreements should include safeguards for financial crises that are not subject to investor-state dispute settlement. They should also exclude short-term investments (“hot money”) and sovereign debt from the definition of investment. See page 9 for more detailed information.

6. Add a General Exception for Environmental and Labor Protections

Some FTAs include an “Investment and Environment” provision that appears to be intended to safeguard environmental regulations from investor-state claims. However, the language could be interpreted as quite meaningless, since it provides protections only for government actions that are “otherwise consistent” with the treaty. Investment rules should include a general exception for measures related to the protection of health, safety and the environment; natural resource conservation; and international human and labor rights. See page 11 for more detailed information.

7. Eliminate the Subsidiary Loophole

“Denial of Benefits” provisions contain a loophole that allows corporations to bypass their own country’s domestic courts by filing investor-state claims through foreign subsidiaries located in a FTA or BIT partner nation. This is explicitly permitted in many agreements, so long as the corporation has “substantial business activities” in the other Party. Since “substantial” is not clearly defined, a U.S.-based corporation could sue the U.S. government by setting up a storefront subsidiary in another country. See page 13 for more detailed information.

8. Prevent Abuse of National Treatment and Most-Favored Nation Obligations

Protecting foreign investors from flagrant discrimination is a basic principle of international trade and investment agreements. However, existing texts open the door to misuse. Under national treatment provisions, an environmental regulation that results in a disproportionate impact on a foreign investor could be considered a violation – even if there is no intentional discrimination. MFN provisions leave open the possibility that foreign investors could claim greater rights than are provided under the treaty agreed to by their home country, a loophole that could lead to a harmonized and enlarged system for investor protection.

9. Allow Performance Requirements that Support Good Jobs

Under existing rules, governments must surrender the authority to impose conditions on foreign investors, such as the requirement to use a certain percentage of local inputs in production, which have been used in the past as responsible economic development tools. While these provisions have had the greatest impact on developing countries, there is growing concern that they could undermine economic development strategies in the United States, including green jobs programs.

10. Create a Level Playing Field Between State-owned and Private Enterprises

As the U.S. government pursues investment agreements with countries that are major capital exporters and that have large state-owned enterprises, it is clear that these deals can no longer be viewed solely as packages of rights for U.S.-based foreign investors. Negotiators should ensure that state-owned enterprises which invest in productive assets in the United States do not receive financing and inputs at below market rates or access to other anti-competitive subsidization by a foreign government.

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See following pages for more detail on several of these proposed changes. This overview drawn largely from: Report of the Subcommittee on Investment of the Advisory Committee on International Economic Policy Regarding the Model Bilateral Investment Treaty – Annex B, September 30, 2009. Collective statement by Sarah Anderson, Institute for Policy Studies; Linda Andros, United Steelworkers; Marcos Orellana Cruz, Center for International Environmental Law; Elizabeth Drake, Stewart and Stewart; Kevin P. Gallagher, Boston University and Global Development and Environment Institute; Owen Herrnstadt, International Association of Machinists and Aerospace Workers; Matthew C. Porterfield, Harrison Institute for Public Law - Georgetown Law; Margrete Strand Ranges, Sierra Club; and Martin Wagner, Earthjustice. Available at: <http://www.state.gov/e/eeb/rls/othr/2009/131118.htm>

Replace the Investor-State Dispute Settlement Mechanism

The investor-state dispute settlement mechanism should be replaced with a state-to-state mechanism. If the administration continues to include an investor-state dispute settlement mechanism, investors should be required to exhaust domestic remedies before filing a claim before an international tribunal. That mechanism should also provide a screen that allows the Parties to prevent frivolous claims or claims which otherwise may cause serious public harm.

Investor-state claims often involve matters of vital importance to the public welfare, the environment, and national security. However, international arbitrators are not ordinarily well-versed in human rights, environmental law, or the social impact of legal rulings. Accordingly, BITs and the investment chapters in free trade agreements (FTAs) should provide only for state-to-state dispute settlement, which guarantees the crucial role of governments in determining and protecting the public interest.

However, if investors are still allowed to file claims against governments before international tribunals, they should at least be required to first exhaust domestic legal remedies. The exhaustion requirement is a fundamental principle of international law.¹ It is also U.S. policy with regard to most claims by U.S. citizens against foreign governments.² There is simply no need for foreign investors to pursue claims against the United States outside of the U.S. judicial system, unless it is in an attempt to obtain greater rights than those provided under U.S. law.

Moreover, many of the countries that the United States is negotiating investment agreements with have strong domestic legal systems. For example, New Zealand, Australia and Singapore, which are among the countries negotiating the Trans-Pacific Partnership Agreement with the United States, are all ranked by the World Bank as performing at least as well as the United States with regard to control of corruption and adherence to rule of law.³

In countries with less well developed legal systems, the exhaustion requirement would promote a key U.S. foreign policy goal – the strengthening of domestic judicial systems. Requiring exhaustion would also restore some balance to a system that currently elevates the interests of foreign investors over other groups – including labor, environmental and human rights organizations – which do not enjoy comparable private rights of action to enforce international legal obligations.

Under international law, the exhaustion requirement does not apply when attempts to use domestic legal remedies would be futile. This would allow investors to proceed to international tribunals if, for example, domestic remedies caused undue delay⁴ or if domestic courts lacked jurisdiction to provide relief.⁵ Even if the domestic courts lacked jurisdiction to hear international law claims, the exhaustion requirement could be satisfied by raising the substance of the claim under domestic law.⁶

1 *Interhandel Case* (Switz. v. U.S.), 1959 I.C.J. Rep. 5, 27 (Mar. 21).

2 See U.S. Department of State, *Bilateral Investment and Other Bilateral Claims*, available at <http://www.state.gov/s/l/c7344.htm>:

Under international law and practice the United States does not formally espouse claims on behalf of U.S. nationals unless the claimant can provide persuasive evidence demonstrating that certain prerequisites have been met. The most important of these requirements [include] that all local remedies have been exhausted or the claimant has demonstrated that attempting to do so would be futile ...

3 See "Governance Matters 2009: Worldwide Governance Indicators, 1996-2008", available at <http://info.worldbank.org/governance/wgi/index.asp>. For 2008, for the governance indicator "rule of law," New Zealand scored in the 97%, Australia in the 95%, Singapore in the 94%, and the United States in the 92%. For the governance indicator "control of corruption" or 2008, for the governance indicator "control of corruption," New Zealand scored in the 98%, Australia in the 96%, Singapore in the 100%, and the United States in the 92%.

4 See, e.g., *El Oro Mining and Railway Co. Case* (Gr. Brit. v. Mex.), 5 Int'l Arb. Awards 191, 198 (Perm. Ct. Arb. 1931).

5 See, e.g., *Panevezys-Saldutiskis Railway (Est. v. Lith.)*, 1939 P.C.I.J. (ser. A/B) No. 76, at 18 (Feb. 28) ("There can be no need to resort to the municipal courts if those courts have no jurisdiction to afford relief. . .") See also generally *The Finnish Ships Case* (Finland v. United Kingdom), 3 R. Int'l Arb. Awards 1484 (1934) (domestic judicial appeal not required where it would not afford a basis for reversing determination of British Admiralty Transport Arbitration Board that the British government had not requisitioned certain Finnish ships).

6 *Elettronica Sicula S.p.A. (ELSI) (U.S. v. Italy)*, 1989 I.C.J. 15, 45-46 (July 20) (exhaustion requirement satisfied where "the substance of the claim" brought in domestic court "is essentially the same" as the international claim).

In addition to requiring exhaustion of domestic remedies, the dispute settlement mechanism for investment agreements should include a diplomatic screen that allows a Party government to prevent claims that the Party believes to be inappropriate, without merit, or would cause serious public harm. The screen mechanism could be based on the provisions in some investment agreements that permit both Parties (*i.e.* both the home state of the investor and the Party whose measure is being challenged) to block certain claims against tax measures or prudential regulations regarding financial services. The screen should apply broadly and include, at a minimum, health and safety, environmental, consumer protection, and human and labor rights measures. Either Party involved in an investment dispute should be able to invoke the screen mechanism to prevent a claim from proceeding.

Limit Claims over the “Minimum Standard of Treatment” to Ensure Compliance with the “No Greater Rights” Principle

Vaguely worded provisions guaranteeing foreign investors a “minimum standard of treatment,” including “fair and equitable treatment,” open the door to investor-state claims over a wide range of government measures that are permissible under the U.S. Constitution. In the case of Glamis Gold v. The United States, U.S. State Department lawyers successfully persuaded the tribunal to accept a relatively narrow interpretation of the MST principle. Since these tribunals are not required to follow judicial precedent, these arguments should be codified in treaty text to prevent arbitrators in future cases from making overly broad interpretations that undermine responsible policymaking.

There is broad, bipartisan support for the principle that the investor protection standards contained in U.S. investment agreements should not provide foreign investors with greater rights than those enjoyed by U.S. investors in the United States. Congress first instructed U.S. negotiators to comply with the “no greater rights” principle in the Trade Act of 2002.⁷ In May 2007, the Bush Administration and the Democratic leadership in the House of Representatives agreed that this principle would be explicitly stated in the preamble of the investment chapters of free trade agreements.⁸ Candidate Obama similarly pledged not to grant foreign investors any rights in the U.S. greater than those of Americans.⁹

The minimum standard of treatment provisions in U.S. investment agreements is intended to reflect the relevant standard under customary international law, which is created through the “general and consistent practice of states followed by them from a sense of legal obligation.”¹⁰ Given that the U.S. Constitution provides among the highest levels of protection for property rights of any country, standards that are based on the general and consistent practice of nations regarding the protection of property rights would generally comply with the no greater rights principle.

Unfortunately, arbitral tribunals have not based their interpretations of the “minimum standard of treatment” provisions of investment agreements on the actual practice of nations, but rather have simply cited the characterization of these standards by other tribunals, using essentially a common law methodology to create “evolving” standards of investor protection.¹¹

In *Glamis Gold v. United States*, the State Department noted that state practice and *opinio juris* had established minimum standards of treatment with regard to foreign investors and investment in only a few areas.¹² Conversely, the State Department rejected Glamis’s assertion that the minimum standard of treatment prohibits either conduct that frustrates an investor’s expectations concerning an investment¹³ or “arbitrary”¹⁴ conduct. Regarding Glamis’s claim that the minimum standard of treatment required compensation for measures that adversely affect an investor’s expectations, the State Department noted

⁷ Trade Act of 2002, H.R. 3009, 107th Cong. § 2102(b)(3) (2002).

⁸ See Office of the United States Trade Representative, Bipartisan Agreement on Trade Policy: Investment (May 2007), available at http://www.ustr.gov/sites/default/files/uploads/factsheets/2007/asset_upload_file146_11282.pdf

⁹ See Pennsylvania Fair Trade Coalition, 2008 Presidential Candidate Questionnaire, answer of Sen. Barack Obama, question 10, available at http://www.citizenstrade.org/pdf/QuestionnairePennsylvaniaFairTradeCoalition040108FINAL_SenatorObamaResponse.pdf. Secretary of State Clinton also endorsed the no greater rights principle during the 2008 campaign. See Texas Fair Trade Coalition, Presidential Candidate Questionnaire, Answer of Sen. Hillary Rodham Clinton, question 6 (“I will ensure that foreign companies do not have greater rights than American companies.”), available at <http://www.texasfairtrade.org/documents/HillaryClintonQuestionnaireResponse.pdf>

¹⁰ RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES, § 102(2) (1987).

¹¹ See generally Matthew C. Porterfield, An International Common Law of Investor Rights? 27 U. Pa. J. Int’l Econ. L. 79 (2006).

¹² See U.S. Counter-Memorial at 221 (footnotes omitted):

Sufficiently broad State practice and *opinio juris* have thus far coincided to establish minimum standards of State conduct in only a few areas. Article 1105(1) embodies, for example, the requirement to provide a minimum level of internal security and law and order, referred to as the customary international law obligation of full protection and security. Similarly, Article 1105 recognizes that a State may incur international responsibility for a “denial of justice” where its judiciary administers justice to aliens in a “notoriously unjust” or “egregious” manner “which offends a sense of judicial propriety.” In addition, the most widely-recognized substantive standard applicable to legislative and rule-making acts in the investment context is the rule barring expropriation without compensation, but that obligation is particularized in the NAFTA under Article 1110.

¹³ See U.S. Counter-Memorial at 233:

While the minimum standard of treatment under customary international law requires compensation in the event of an expropriation, there is no such rule requiring compensation for actions that fall short of an expropriation but that frustrate an alien’s expectations. Certainly, Glamis has made no showing that States refrain out of a sense of legal obligation from taking regulatory action that may frustrate an alien’s expectations. Indeed, most, if not all, regulatory action is bound to upset the expectations of a portion of the populace. If States were prohibited from regulating in any manner that frustrated expectations – or had to compensate everyone who suffered any diminution in profit because of a regulation – States would lose the power to regulate.

¹⁴ See U.S. Counter-Memorial at 227 (“Glamis has also failed to present any evidence of relevant State practice to support its contention that Article 1105(1) imposes a general obligation on States to refrain from ‘arbitrary’ conduct.”)

that such an interpretation was both inconsistent with the no greater rights mandate and unsupported by state practice.¹⁵

The asserted right to compensation for government measures that a tribunal deems “arbitrary” would similarly provide greater rights than the comparable standard under U.S. law. The Administrative Procedure Act does provide for review of certain final agency actions under an “arbitrary and capricious” standard of review. No comparable standard of review for economic legislation has been available, however, since the 1930s, when the Supreme Court abandoned the aggressive substantive due process review of the *Lochner* era.¹⁶ Although substantive due process review of economic legislation remains theoretically possible, the post-*Lochner* standard is a highly deferential “minimum rationality” review, pursuant to which legislation will be upheld “unless in the light of the facts made known or generally assumed it is of such a character as to preclude the assumption that it rests upon some rational basis within the knowledge and experience of the legislators.”¹⁷

Not only would an international “arbitrary” standard of review for economic legislation provide greater rights than the highly deferential standard of review for substantive due process claims, it would also exceed the standard of protection afforded under the domestic law of other developed countries. The Supreme Court’s *Lochner* era jurisprudence, in fact, “stands as perhaps the paradigmatic instance of an ‘anti-model’ of comparative constitutional experience.”¹⁸ Accordingly, future U.S. investment agreements should codify the State Department’s deferential interpretation of the minimum standard of treatment.

15 See U.S. Counter-Memorial at 234 and note 1017 (“United States law does not compensate plaintiffs solely upon a showing that regulations interfered with their expectations, as such a showing is insufficient to support a regulatory takings claim . . . It is inconceivable that the minimum standard of treatment required by international law would proscribe action commonly undertaken by States pursuant to national law.”)

16 *Motor Vehicle Mfrs. Ass’n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 n.9. (1983) (rejecting suggestion that “the arbitrary and capricious standard [under the APA] requires no more than the minimum rationality a statute must bear in order to withstand analysis under the Due Process Clause. We do not view as equivalent the presumption of constitutionality afforded legislation drafted by Congress and the presumption of regularity afforded an agency in fulfilling its statutory mandate.”)

17 *United States v. Carolene Products*, 304 U.S. 144, 152 (1938). In the context of exercises of executive authority, the Supreme Court has indicated that conduct that “shocks the conscience” violates substantive due process. See *County of Sacramento v. Lewis*, 523 U.S. 833, 846 (1998). Although the Court has not applied this standard to economic legislation, it is arguably comparable to the current deferential standard of substantive due process review of economic regulations. Accordingly, given the similarity of the “conscience shocking” formulation of substantive due process to the traditional *Neer* test for the minimum standard of treatment, the *Neer* standard could be interpreted as consistent with the “no greater rights” principle.

18 Sujit Choudhry, *The Lochner Era and Comparative Constitutionalism*, 2 *Int’l J. Const. L.* 1, 3 (2004).

Limit Claims over “Indirect Expropriation” to Comply with the “No Greater Rights” Principle

U.S. investment agreements should clarify that an “indirect expropriation” occurs only when a host state seizes or appropriates an investment for its own use or the use of a third party, and that regulatory measures that adversely affect the value of an investment but do not transfer ownership of the investment do not constitute acts of indirect expropriation.

Recent U.S. investment agreements contain several important clarifications concerning the standard for “indirect expropriation.” Three provisions in particular are significant: language indicating that the standard is intended to reflect customary international law concerning the obligation of States with respect to expropriation,¹⁹ provisions indicating that in order to constitute an expropriation a measure must affect a property right,²⁰ and language indicating that “[e]xcept in rare circumstances, non-discriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as health, safety and the environment, do not constitute indirect expropriations.”²¹

Despite these reforms, however, there remains the potential that the indirect expropriation provisions of investment agreements could be applied in a manner that would violate the “no greater rights” principle by providing foreign investors with greater rights than the comparable protections of the Takings Clause of the Fifth Amendment of the U.S. Constitution.²² For example, U.S. investment agreements typically permit tax measures to be challenged as violations of the prohibition on uncompensated expropriations,²³ and there is substantial precedent in international arbitral practice for finding that tax measures can constitute forms of indirect expropriation.²⁴ Under the Fifth Amendment’s Takings Clause, in contrast, the Supreme Court has repeatedly rejected takings challenges to tax measures, even when the tax is set at a level that threatens the viability of a business.²⁵

The restriction of expropriation claims to situations involving “property” as opposed to the more broadly defined “investment” is also inadequate to ensure compliance with the “no greater rights” principle, because it does not reflect that the requirement of compensation for “regulatory takings” under the Fifth Amendment of the U.S. Constitution has generally been only held to apply to regulations affecting *real* property.²⁶ For example, the Supreme Court has indicated that personal property is unlikely to be the basis for a successful regulatory takings claim given that “in the case of personal property, by reason of the State’s traditionally high degree of control over commercial dealings, [the owner] ought to be aware of the possibility that new regulation might even render his property economically worthless.”²⁷

Moreover, the indirect expropriation provision in investment agreements has been interpreted to require compensation based on the impact of the government measure on the value of the investment,

19 See 2004 Model BIT, Annex B, para. 1.

20 See 2004 Model BIT, Annex B, para. 2.

21 *Id.*, para 4(b).

22 See generally, Matthew C. Porterfield, International Expropriation Rules and Federalism, 23 *Stanford Env’tl L. J.* 3, 43-62 (2004) (comparing international standard for regulatory expropriation with U.S. regulatory takings doctrine).

23 See 2004 Model BIT, Article 21 (Taxation).

24 See generally Thomas W. Wälde and Abba Kolo, Taxation and Modern Investment Treaties, in *The Oxford Handbook of International Investment Law* at 347 - 352 (2008).

25 See, e.g., *Pittsburgh v. Alco Parking Corp.*, 417 U.S. 369, 373 (1974) (rejecting a takings challenge to a tax on gross receipts from parking facilities, and noting that “the Court has consistently refused either to undertake the task of passing on the ‘reasonableness’ of a tax that otherwise is within the power of Congress or of state legislative authorities, or to hold that a tax is unconstitutional because it renders a business unprofitable.”)

26 See Eduardo Moisés Peñalver, *Is Land Special?* 31 *Ecology L.Q.* 227, 231 (2004) (“it is almost beyond dispute that . . . the [Supreme] Court has focused overwhelmingly on regulations affecting land and that landowners bringing regulatory takings claims stand a greater chance of prevailing in the Supreme Court than the owners of other sorts of property”); Molly S. McUsic, *The Ghost of Lochner: Modern Takings Doctrine and Its Impact on Economic Legislation*, 76 *B.U. L. Rev.* 605, 647, 655 (1996) (“Economic interests, such as personal property, trade secrets, copyright, and money, are all recognized by the Court as ‘property’ under the Fifth Amendment, but receive little protection against government regulation.”) J. Peter Byrne, *Ten Arguments for the Abolition of Regulatory Takings Doctrine*, 22 *Ecology L.Q.* 89, 127 (1995) (“the Supreme Court has shown absolutely no interest in applying the regulatory takings doctrine to assets other than land”).

27 *Lucas v. South Carolina Coastal Comm’n*, 505 U.S. 1003, 1027-28 (1992). The Supreme Court’s decision in *Ruckelshaus v. Monsanto Co.*, 467 U.S. 986 (1984), which involves a claim that the disclosure of trade secrets by the federal government constituted a taking, is sometimes cited as an example of the application of the regulatory takings analysis outside the context of real property. The Court in *Monsanto*, however, stressed that “[w]ith respect to a trade secret, the right to exclude others is central to the very definition of the property interest. Once the data that constitute a trade secret are disclosed to others, or others are allowed to use those data, the holder of the trade secret has lost his property interest in the data.” *Monsanto*, 467 U.S. at 1012. Accordingly, “*Monsanto* is a case in which the government conduct in question was the functional equivalent of a direct appropriation of the entire piece of property, as opposed to a mere regulation of that property.” Eduardo Moisés Peñalver, *Is Land Special?* 31 *Ecology L.Q.* 227, 231, n. 20 (2004).

regardless of whether there has actually been some appropriation of an asset by the government.²⁸ This interpretation of the standard for indirect expropriation cannot be justified as reflecting the general practice of states, given that the dominant practice of nations is to provide for compensation only when the government has actually acquired an asset, not when the value of an asset has been adversely affected by regulatory measures.²⁹

Accordingly, future U.S. investment agreements should include text clarify that an indirect expropriation occurs only when the government acts indirectly to seize or transfer ownership of an investment, and not when the government merely acts in a manner that decreases the value of profitability of an investment. This approach would be consistent with both the “no greater rights” mandate and the general practice of states that forms the basis of customary international law. It would exclude from the compensation requirement only a very narrow class of non-confiscatory regulatory measures that would be compensable under U.S. law (although not under the legal systems of most other countries).

²⁸ Andrew Newcombe, *The Boundaries of Regulatory Expropriation in International Law*, 20:1 ICSID Review – FILJ at 4 (2005) (noting that “under the ‘orthodox approach’ [a regulatory] expropriation occurs when a foreign investor is deprived of the use, benefit, management or enjoyment of all or substantially all of its investment” rather than whether the government has actually appropriated the investment for its own use).

²⁹ See A.J. Van der Walt, *Constitutional Property Clauses: A Comparative Analysis* (1999) at 17 (“the distinction between police-power regulation of property and eminent-domain expropriation of property is fundamental to all [constitutional] property clauses, because only the latter is compensated as a rule. Normally, there will be no provision for compensation for deprivations or losses caused by police-power regulation of property.”) United States law is an exception in this regard, and under certain circumstances – most notably in the “rare circumstance” when a regulatory measure destroys all value of real property – requires compensation even when there has been no appropriation of the property by the government. See *Lucas v. South Carolina Coastal Comm’n*, 505 U.S. 1003 (1992).

Allow Policies to Prevent and Mitigate Financial Crisis

by Sarah Anderson and Kevin Gallagher³⁰

Existing U.S. free trade agreements (FTAs) and bilateral investment treaties (BITs) undermine global financial stability in numerous ways that threaten the livelihoods of working families in the United States and its trading partners. The financial services chapters of FTAs promote a deregulatory approach that could prevent the use of legitimate policy tools to prevent and mitigate future crises. This fact sheet focuses on the investment chapters of FTAs (and similar rules in BITs), highlighting two key areas that relate to financial stability: 1) restrictions on capital controls and financial speculation taxes and 2) the inclusion of sovereign debt as a “covered investment.”

Restrictions on Capital Controls and Financial Speculation Taxes

The “transfers” sections of U.S. FTAs and BITs require governments to permit all transfers relating to a covered investment to be made “freely and without delay into and out of its territory.” In effect, these rules require capital account liberalization between the treaty partners, without exception.³¹

Problems:

- **Prohibiting capital controls conflicts with contemporary economic thinking.** A February 2010 IMF report found that nations which deployed controls on inflows before the current crisis were among the least hard hit. The IMF concluded that capital controls are a legitimate policy tool for preventing and mitigating crises, a view echoed by the Asian Development Bank and United Nations. IMF, World Bank, and Cornell University research over a longer timeline has found no correlation between capital account liberalization and economic growth in developing countries.³²
- **Such provisions are inconsistent with other treaties.** The IMF has long argued for safeguard measures to allow capital controls on inflows or outflows to prevent or mitigate crisis. Recent UN research shows that the trade and investment agreements of virtually every other major capital exporter include such a safeguard.³³
- **Existing rules could prohibit financial speculation taxes.** There is growing momentum in the United States and around the world behind proposals to apply small transactions taxes on stock, derivatives, currency, and other financial instruments as a way to curb speculation and generate revenue for jobs and other urgent needs. Under existing FTAs, foreign investors could argue that such taxes violate their right to transfer investments “freely and without delay.” And while some FTAs carve out many types of taxation from expropriation obligations, they do not explicitly exempt them from transfers provisions.
- **Special exceptions in some U.S. agreements are inadequate.** U.S. FTAs and BITs allow private foreign investors to sue governments in supra-national tribunals that have no public accountability, standard judicial ethics rules, or appeals process. A handful of recent U.S. trade agreements have included a special dispute settlement procedure for investor-state claims related to transfers. Annex 10-E of the U.S.-Peru FTA, for example, limits damages arising from certain restrictive measures on capital inflows to the reduction in value of the transfers. Investors may not demand compensation for the loss of profits or business. In addition, there is an extended “cooling off” period before investors may file claims. While a step in the right direction, these provisions still place undue restrictions on the authority to use capital controls.

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31 Anderson, Sarah. Policy Handcuffs in the Financial Crisis, Institute for Policy Studies, February 2009. Available at: <http://www.ips-dc.org/files/329/Policy%20Handcuffs%20in%20the%20Financial%20Crisis.pdf>; and Comments on the U.S. Model Bilateral Investment Treaty before the U.S. State Department and USTR, July 17, 2009. Available at: <http://www.ips-dc.org/files/1366/IPS%20comments%20on%20Model%20Bilateral%20Investment%20Treaty.pdf>

32 Kose MA, Prasad E and Taylor AD (2009). Thresholds on the Process of International Financial Integration. NBER Working Paper 14916. Cambridge, MA, National Bureau of Economic Research.

33 Gallagher, Kevin P (2010). Policy space to Prevent and Mitigate Financial Crises, UNCTAD-G-24 Discussion Paper #58, Geneva: UNCTAD. Available at: <http://www.ase.tufts.edu/gdae/Pubs/rp/KGCapControlsG-24.pdf>

Sovereign Debt

Many governments enter a financial crisis with high debt levels. Still more borrow on bond markets for bailouts or stimulus programs and then experience slow growth and low tax revenues that push them to the brink of default. The U.S. government has long advocated sovereign debt restructuring as an alternative to IMF- or U.S. taxpayer-financed bailouts.

Problems:

- **Recent U.S. trade and investment agreements treat sovereign debt as an “investment” and therefore may restrict governments’ ability to restructure debt and recover from crises.** Restructuring, by definition, reduces the value of a sovereign bond and can thus be seen as a violation of not only the transfers provisions, but also of “fair and equitable treatment” and “expropriation.” By filing investor-state claims under FTAs or BITs, bondholders can circumvent official restructuring processes. For example, Italian bondholders sued Argentina to recoup the full value of their original bonds.
- **Special exceptions in some U.S. agreements are inadequate.** Some recent deals include annexes that do not permit debt-related claims during a restructuring unless the measures violate national treatment or most favored nation provisions. However, a nation in crisis may be justified in giving domestic bondholders priority to protect the banking system or ensure fulfillment of wage and pension commitments.

Both the capital control and sovereign debt provisions in U.S. FTAs and BITs threaten livelihoods in trading partner nations – and in the United States. As we have learned from the contagious meltdowns in Iceland, Greece, and this country, global financial markets are extremely integrated. Thus, U.S. working families are made vulnerable when governments anywhere lack the tools they need to prevent and mitigate crisis. The European debt crisis has devastated an important U.S. export market (as did the 1997 Asian financial crisis) – at great cost to American jobs. U.S. foreign investors also face risks. Uncontrolled massive capital flight often leads to significant currency depreciations, which reduce the value of U.S. investors’ revenues in the host country and increase the cost of any imported inputs. The impact on our trading partners can be even graver, as a crisis can set back a nation’s financial system and halt growth, employment, and poverty reduction for years to come.

Recommendations:

U.S. trade agreements and bilateral investment treaties should not restrict a government’s authority to use capital controls and restructure sovereign debt to prevent and mitigate financial crisis. At a minimum, changes should be made to:

1. allow a government to restrict a transfer through the equitable, non-discriminatory, and good faith application of its laws related to macroeconomic, monetary, or exchange rate policy.
2. establish safeguard mechanisms for financial crises that are not subject to investor-state dispute settlement. At most, the provisions should be subject to state-to-state dispute settlement and even then such procedures should only be available after a consultation process.
3. exclude short-term investment (“hot money”) and sovereign debt from the definition of investment.

Add a General Exception for Environmental and Labor Protections

By Rachel Ackoff, Sierra Club

An across the board exception for health, safety and environmental measures is needed to allow the U.S. government and the governments of our trading partners to protect people and environment. Without a general exception for health, safety and environmental measures in our free trade agreements, our public interest laws are vulnerable to challenges.

The closest our model bilateral investment treaty (BIT) comes to a general exception is Article 12.2, which states that: “Nothing in this Treaty shall be construed to prevent a Party from adopting, maintaining, or enforcing any measure *otherwise consistent with this Treaty* that it considers appropriate to ensure that investment activity in its territory is undertaken in a manner sensitive to environmental concerns (emphasis added).” However, such an exception does not solve the problem as it only protects health, safety, and environmental laws that should not be challenged by investors in the first place because they are consistent with the investor protections in the agreement.

Our trade agreements currently have a patchwork of exceptions for public interest laws. For instance, in Article 8 of the Model BIT regarding performance requirements, there is an exception for measures necessary to protect human, animal, or plant life or health, or related to the conservation of living or non-living exhaustible natural resources (Article 8.3). While this exception is no doubt important in this particular context, an exception for these measures should be designed to apply to the whole agreement. The fact that the exception only applies to performance requirements leads the treaty interpreter to question whether the drafters intended to have provisions in other areas of the agreement always trump public interest laws.

The omission of a general exception introduces a high level of uncertainty regarding the legality of measures adopted by governments to protect their people and environment from threats to people or the environment. It becomes a matter of interpretation where one tribunal could decide one way and another decide a different way and no decision sets an official precedent for future decisions. Consequently, there is no certainty that an investment tribunal will interpret the substantive rules in a way that provides sufficient flexibility to safeguard the regulatory needs of the host government. This uncertainty reduces the ability of the government to effectively respond to risks. A general exceptions clause would make explicit what may be implicit, thereby providing guidance to tribunals as well as certainty to the law in a critical area of public policy.

The General Agreement on Tariffs and Trade (GATT), contains general exceptions in Article XX for measures necessary for the protection of human, animal or plant life or health, or that relate to the conservation of exhaustible natural resources, provided that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade. These exceptions have been critical in ensuring that the United States can adopt measures to protect the environment and natural resources. For example, in *US-Shrimp Turtle* decided under the World Trade Organization, the general exceptions in Article XX of the GATT were critical to upholding the legality of U.S. measures adopted to protect endangered sea turtles.

The US-Peru Free Trade Agreement included general exceptions for laws to protect human, animal, or plant health or life modeled after the GATT’s general exceptions:

Article 22.1: General Exceptions

1. For purposes of Chapters Two through Seven (National Treatment and Market Access for Goods, Textiles and Apparel, Rules of Origin and Origin Procedures, Customs Administration and Trade Facilitation, Sanitary and Phytosanitary Measures, and Technical Barriers to Trade), Article XX of the GATT 1994 and its interpretive notes are incorporated into and made part of this Agreement, *mutatis mutandis*. The Parties understand that the measures referred to in Article XX(b) of the GATT 1994 include environmental measures necessary to protect human, animal, or plant life or health, and that Article XX(g) of the GATT 1994 applies to measures relating to the conservation of living and non-living exhaustible natural resources.

2. For purposes of Chapters Eleven, Fourteen, and Fifteen¹ (Cross-Border Trade in Services, Telecommunications, and Electronic Commerce), Article XIV of the GATS (including its footnotes) is incorporated into and made part of this Agreement, *mutatis mutandis*. The Parties understand that the measures referred to in Article XIV(b) of the GATS include environmental measures necessary to protect human, animal, or plant life or health.

However, Peru's general exception for health, safety, and environmental measures only applies to Chapters 2-7 and 11, 14, and 15. It does not apply to the investment chapter, Chapter 10. The general exception should be applied to the entire agreement.

In addition, in the Peru FTA, the burden of proof remains on the governments to prove that their public interest laws are legitimate environmental laws and not discriminatory rather than on the investors. Only in the general exception for essential security in the Peru FTA does the text state that "For greater certainty, if a Party invokes Article 22.2 in an arbitral proceeding initiated under Chapter Ten (Investment) or Chapter Twenty-One (Dispute Settlement), the tribunal or panel hearing the matter shall find that the exception applies." In other words, it is automatically ensured that a challenge to a law protecting a country's essential security will be dismissed. It would be extremely beneficial to extend such certainty to the realm of health, safety, and environment. If however, a form of proof is required the burden should fall on the investor bringing the suit to show that a public interest law is discriminatory in nature.

The US Model BIT, the Transpacific Partnership Free Trade Agreement, and every future US trade or investment agreement should include a general exception for health, safety, and environmental measures that applies to the entire agreement and that shifts the burden of proof for defending their public interest laws away from governments.

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Eliminate the Subsidiary Loophole

by Todd Tucker, Public Citizen

“Denial of Benefits” provisions contain a loophole that allows corporations to bypass their own country’s domestic courts by filing investor-state claims through foreign subsidiaries located in a FTA or BIT partner nation. This is explicitly permitted in many agreements, so long as the corporation has “substantial business activities” in the other Party. Since “substantial” is not clearly defined, a U.S.-based corporation could sue the U.S. government by setting up a storefront subsidiary in another country.

Despite (or arguably, because of) their “Denial of Benefits” provisions, existing U.S. FTAs or BITs allow investors from non-Party countries – or even subsidiaries of U.S. corporations – to launch investor-state cases against U.S. regulations, as diverse commentators on all sides of the trade debate have noted.³⁴ A wide range of investor-state tribunals – including some constituted under BITs that have nearly identical “denial of benefits” clauses to recent U.S. FTAs or BITs – have made troubling rulings that would allow unfair “nationality-shopping” practices.³⁵ Moreover, rulings under the plurilateral Energy Charter Treaty have ruled that ECT respondent state A will have a hard time denying benefits to an investor that claims to be from ECT state B – but is controlled by nations outside ECT state B and/or lacks substantial business activities in ECT state B – if it can be shown that some layer of its corporate veil (not even necessarily the veil indicating ultimate beneficial ownership) comes from ECT states C and D.³⁶

The TPP negotiations offer an opportunity to craft a 21st century trade agreement that can more definitively deal with that most 21st century of issues: how to deal with complex international corporate structures³⁷ in a way that encourages sustainable investment flows, and discourages “free riding” and “treaty shopping” on the part of multinational corporations. Multinationals often incorporate subsidiaries in diverse jurisdictions so as to minimize exposure to their home country’s tax and regulatory jurisdiction; it would be fundamentally unfair to then reward them for the practice by maximizing the investment protection they can derive from the practice. There are several problems that need to be solved:

1. How to define standing so that it corresponds to applicable domestic law;
2. How and when is “denial of benefits” triggered;
3. How to define “substantial business activities” so that they have a real-world, economic basis, rather than merely reflecting legal artifices;
4. How to define the relevant duration of these “substantial business activities”, so as to avoid opportunistic “nationality planning” in the lead-up to initiation of arbitral proceedings;
5. In the case of bilateral agreements like the Korea FTA, how to ensure that potential claimants have substantial business activities in both their home and host country;
6. In the case of plurilateral agreements (like the ECT and TPP), how to ensure that potential claimants have substantial business activities in the specific home and host countries they are claiming in their

34 Report of the Subcommittee on Investment of the Advisory Committee on International Economic Policy Regarding the Model Bilateral Investment Treaty, Annex B, Anderson et. al collective statement, Sept. 30, 2009. Available at: <http://www.state.gov/e/eeb/rls/othr/2009/131118.htm>. Statement of Linda Menghetti, Emergency Committee for American Trade, Before Committee on Ways & Means, May 14, 2009. Available at <http://waysandmeans.house.gov/Hearings/Testimony.aspx?TID=8180>. Mark Kantor, “International investment law protections for Chinese investment into the US,” in Karl Sauvant, ed., *Investing in the United States: Is the US Ready for FDI from China?* (Northampton, MA: Edward Elgar, 2010), at 142, 146

35 See discussion in Rachel Thorn & Jennifer Doucleff, “Disregarding the Corporate Veil and Denial of Benefits Clauses: Testing Treaty Language and the Concept of ‘Investor’”, in Michael Waibel, Asha Kaushal, Kyo-Hwa Liz Chung, and Claire Balchin (eds.), *The Backlash against Investment Arbitration*, (Netherlands: Kluwer Law International, 2010)

36 In *Hulley Enterprises v. Russia*, the claimants claimed to be from Cyprus and Isle of Man. Isle of Man is a crown dependency of the U.K., and both Cyprus and Isle of Man are notorious tax and regulatory havens. After an examination of the evidence, the tribunal determined that the claimants were in fact owned and controlled by investors incorporated in Gibraltar and Guernsey – the former a U.K. overseas territory and the other a crown dependency, and also both tax and regulatory havens. Because the U.K. is in the ECT, it didn’t matter that the investors were not from where they said they were. Russia argued that the beneficial owners of the Gibraltar and Guernsey investors were Russian or Israeli nationals. The tribunal ruled that Russian investors would not be prohibited from challenging Russian regulations under the “denial of benefits” provisions of the ECT, and did not specifically determine the claim about Israeli beneficial ownership. PCA Case No. AA 226, *In The Matter Of An Arbitration Before A Tribunal Constituted In Accordance With Article 26 Of The Energy Charter Treaty And The Uncitral Arbitration Rules 1976 Between Hulley Enterprises Limited (Cyprus) And The Russian Federation, Interim Award On Jurisdiction And Admissibility*, Nov. 30, 2009, at paras 537-55. In *AMTO v. Ukraine*, the Latvian corporation had owners or boardmembers in Latvia, Liechtenstein, the U.S., and Cyprus, and the tribunal determined it was ultimately controlled by a Russian. Because Russia is also party to the ECT (along with Latvia and Ukraine), the tribunal seemed ready to accept standing (but did not rule because of an equally troubling determination on “substantial business activities” – see below).

37 Indeed, the *Aucoven v. Venezuela* tribunal noted, with regard to complex holding company structures, what the respondent state alleged to be a “mere formality is the fundamental building block of the global economy.” Quoted in Thorn and Doucleff, at 18.

notice of intent, rather than in other countries that are party to the agreement but not being cited in the notice of intent;

7. In both cases, how to ensure that nationals of a given country are not challenging their own country's regulations;
8. What guidance to give to arbitral panels on when and how deeply to "pierce the corporate veil" to determine ultimate beneficial ownership; and
9. How to allocate the burden of proof on these matters.

A clear option that resolves many of these points is to simply alter the "denial of benefits" and definition of investment and substantial business activities to "hyperlink" to the applicable domestic legal standard. The virtue of this approach is that it does not attempt to freeze definitions in international law that can and should change domestically in response to changed policy objectives and an evolution of constitutional understanding. Anti-abuse provisions can accompany these reforms so as to guard against governments changing definitions just to harass a foreign investor.

Alternatively, and leaving aside the paragraph in U.S. FTAs dealing with non-recognition of countries like Cuba, the TPP "Denial of Benefits" Article could read as in the left column of the table below, with commentary in the right column:

<p><i>2. Under this Article, an investor-state dispute shall be seen as arising between an investor of a single home Party in regards to their investment of a single host Party. The benefits of this Chapter shall be denied to an investor of the home Party that is an enterprise of such home Party and to investments of that investor if the enterprise has no substantial business activities in the territory of the home Party and persons of a non-Party, or of the host Party, are its beneficial owners.</i></p>	<p>The passage "The benefits of this Chapter shall be denied to an investor..." copies the ASEAN Framework Agreement on Services, which might make inherent sense given that the TPP is partially aimed at deepening ties between the U.S. and Asian countries.³⁸</p> <p>This language also eliminates the ambiguity that may arise as to whether a potential respondent government has to affirmatively take action to deny benefits. In fact, the tribunal in <i>Hulley Enterprises v. Russia</i> explicitly stated that the parties to the Energy Charter (which includes Russia, the U.S., and others) would have had to include such language if they wanted denial of benefits to be self-invoking.³⁹</p>
<p><i>(a) For the purposes of this Article, "substantial business activities" means average per capita purchases or sales of goods or services in the territory of the home Party that is at least 20 percent the annual average, purchasing power parity-adjusted, per capita purchases or sales of goods or services realized in its primary market (which may be either the host Party, home Party, or non-Party), in the six years prior to the date of the alleged injury.</i></p> <p><i>(b) An investor shall be considered to be of the host Party and not of the home Party if, in the six years prior to the date of the alleged injury, it has, on an annual average, purchasing power parity-adjusted basis, conducted greater purchases or sales of goods or services in the territory of the host Party than in the territory of the home Party.</i></p>	<p>This establishes several economic, real-world thresholds for the definition of "substantial business activities." This addresses the problem from the <i>AMTO v. Ukraine</i> case, where the presence of two employees and a small paper trail in Latvia was seen as evidence of "substantial business activities" in the claimed home Party.⁴⁰</p> <p>The threshold considers either purchases or sales, recognizing that many investors may not make wholesale or retail sales. For such firms, a purchase threshold of goods and services may be more appropriate.</p> <p>There's only a <i>de minimis</i> threshold of purchases or sales in the home Party, so as to not overly interfere with business prerogatives: an investor could still do the vast majority of its operations in third Party markets and still be considered as originating in the home Party.</p>

³⁸ That Agreement states that, "The benefits of this Framework Agreement shall be denied to a service supplier who is a natural person of a non-Member State or a juridical person owned or controlled by persons of a non-Member State constituted under the laws of a Member State, but not engaged in substantive business operations in the territory of Member State(s)" [italics added] See <http://www.aseansec.org/6628.htm>

³⁹ <http://ita.law.uvic.ca/documents/HELvRussianFederation-InterimAward-30Nov2009.pdf> at 165.

⁴⁰ Arbitration Institute Of The Stockholm Chamber Of Commerce, Arbitration Number 080/2005, In The Matter Of: An arbitration pursuant to the Energy Charter Treaty and the Rules of the Arbitration Institute of the Stockholm Chamber of Commerce: Limited Liability Company Amto (Claimant) v. Ukraine (Respondent), Final Award, March 26, 2008, at para 69. Available at: <http://ita.law.uvic.ca/documents/AmtoAward.pdf>.

	<p>There is a higher threshold for defining whether an investor is suing its own government, since the abuse more clearly cuts against the purpose of BITS: there must be greater purchases or sales in the home Party than in the host Party.</p> <p>In both cases, the TPP could adopt the six year requirement referenced by tribunalists Daniel Price and Piero Bernardini from the <i>Tokios Tokelés</i> case, which thought that an enterprise incorporation six years prior to the attempt to access investor-state arbitration was evidence that the corporation was not engaging in “an abuse of legal personality.”⁴¹</p>
<p><i>(c) The existence of “substantial business activities” in a Party that is neither the home Party nor host Party shall not constitute “substantial business activities” for the purposes of this Article. For the purposes of determining beneficial ownership, “non-Party” includes Parties that are neither the home Party nor the host Party.</i></p>	<p>This contains a method for guarding against aggressive “nationality planning” in larger regional or plurilateral agreements, like the TPP. So, if a tribunal denied benefits to a Vietnamese investor in a challenge to U.S. regulations because the investor was not controlled by Vietnamese persons (or had no substantial business activities in Vietnam), then the fact that the investor was controlled instead by Australians (or had substantial business activities in Australia) would not function to reestablish standing... even though Australia is also party to the TPP. (As noted above, this has been a problem in various Energy Charter Treaty cases.)</p>
<p><i>(d) The term “beneficial owner” means all natural or juridical persons who, directly or indirectly, exercise substantial control over the covered investment; or have a substantial interest in or receive substantial economic benefits from the investment. For greater clarity, an investor must disclose the names and contact information for all of its ultimate beneficial owners in its Notice of Arbitration.</i></p> <p><i>(e) Once a tribunal has found a basis for denying benefits under this article, an investor may attempt to prove that this conclusion was wrongly arrived at, by, for instance, proving that beneficial ownership belongs to a natural person of the home Party.</i></p>	<p>An investor must furnish information to the tribunal about all the natural persons who are its beneficial owners, so that the tribunal can make a rebuttable determination about whether denial of benefits is appropriate.</p> <p>The definitions for “beneficial ownership” are based on language on transparency legislation now being discussed in Congress.</p>

⁴¹ “We are satisfied, however, that none of the Claimant’s conduct with respect to its status as an entity of Lithuania constitutes an abuse of legal personality... The Claimant manifestly did not create Tokios Tokelés for the purpose of gaining access to ICSID arbitration under the BIT against Ukraine, as the enterprise was founded six years before the BIT between Ukraine and Lithuania entered into force.” Majority Opinion in *Tokios Tokelés v. Ukraine* case, at 24.