TOWARDS COMPREHENSIVE REFORM OF INVESTMENT PROTECTION

FROM A REGIME OF PRIVILEGES TO A LEVEL PLAYING FIELD

A study commissioned by The Greens/EFA Group in the European Parliament

THE GREENS/EFA In the European Parliament

Written by Markus Krajewski
School of Law, University of Erlangen-Nürnberg,
contact: markus.krajewski@fau.de

FOREWORD

What makes a good legal judgment? Good adjudicators? Good laws? Both? Hardly surprisingly, I believe that we need both.

International Investment Agreements (IIAs) containing investor-state dispute settlement (ISDS) are notorious for producing controversial and costly litigation against state's public policies.
To address this problem, the EU is replacing ad-hoc arbitration by rosters of judges (Investment Court System, or ICS) in its new agreements, and pushing to create a Multilateral Investment Court (MIC) to manage disputes. However, the substance of agreements - the rules on which cases are based, has yet to change significantly.

With this study, we want to contribute to filling this gap.

We are not the only ones thinking that change must go beyond procedure. In the Energy Charter Treaty (ECT) modernisation negotiations, the EU chose an innovative approach. The EU's position aims to exclude protections for new fossil fuel investments. Despite unfortunate loopholes, this shows a will to prevent the worse of ISDS-related climate litigation by changing the substance of an agreement.

The approach presented here is different but complementary. It focuses on limiting protection standards, and proposes language to protect our regulatory space.

Improving the substance of investment agreements is urgent. Treaty-based investor-state dispute settlement cases passed the 1000 mark at the end of 2019, with an increasing number of cases launched against European Member states and the EU itself. Every single of the known cases initiated in 2019 are based on old generation investment treaties, signed before 2012. Those contain neither procedural not substantive changes to shield legitimate public policies, and are largely incompatible with EU law.

Meanwhile, both the EU and the EU member states continue to conclude new investment agreements, containing outdated protection standards.

The urgency of the climate crisis is putting investment protection back in the spotlight. Policy makers in Europe rightly see the risk of massive climate litigation arising from the thousands of existing treaties. The risk also exists for other important public policies, from health to tax policy. We need to terminate or replace old treaties with modern ones, and to take these risks into account when considering new investment agreements. This study contains important proposals to that effect.

Anna Cavazzini MEP

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Technical Summary

This study develops proposals for a reform of EU investment protection agreements and investment protection chapters in EU Free Trade Agreements. The current approach of the EU of focussing predominantly on the reform of the dispute settlement mechanism by replacing the traditional investor state dispute settlement model through arbitration (ISDS) with an Investment Court System (ICS) falls short of a fundamental reform and may in fact exacerbate the problems of investment protection, which are rooted in the substantive parts of the agreement. At the core of these problems is the fact that investment protection agreements or chapters typically contain standards of protection which are only available to foreign investors and which may therefore lead to a disproportionate weight of foreign investors' interests, having a negative impact on domestic political compromises as a result.

The study therefore suggests limiting the substance of investment protection to the principles of non-discrimination (national treatment and most favoured nation treatment) and to compensation for expropriation, as these standards serve to provide a level playing field between foreign and domestic investors. The problematic standard of fair and equitable treatment (FET) – regardless of how narrow it is defined – should be avoided. Furthermore, the study suggests incorporating general and broad exception clauses which serve to protect public policy spaces in a much more effective and nuanced manner than the so-called "right to regulate"-clauses, which usually only contain language that has little practical effect. Concrete textual proposals are attached to the study. The language of these builds on existing EU investment protection chapters in the free trade agreements with Canada (Comprehensive Economic and Trade Agreement, CETA).

1. Background

The ongoing debate about the reform of international investment agreements is currently dominated by a reform of dispute settlement mechanisms[1]. The EU is actively promoting its new model, an Investment Court System (ICS) which is incorporated in CETA as well as the agreements of the EU with Vietnam and Singapore. The EU also introduced this model in the current negotiations in investment protection reform in UNCITRAL[2]. There have been many comments and reflections on this idea so far: While some actors, including many mainstream investment law experts as well as the EU institutions, in particular the EU Commission, see it as a progressive and new model which addresses the problems of the traditional Investor-State Dispute Settlement (ISDS) mechanism, non-governmental organisations and critical academic commentators consider this

[1] Anthea Roberts, Incremental, Systemic, and Paradigmatic Reform of Investor-State Arbitration, 112 American Journal of International Law (2018), pp. 410 - 432; Catherine Titi, Recent Developments in International Investment Law, European Yearbook of International Economic Law 2018 , pp. 383-403.

[2] European Commission, Submission of the European Union and its Member States to UNCITRAL Working Group III - 18 January 2019 - Establishing a standing mechanism for the settlement of international investment disputes, available at https://trade.ec.europa.eu/doclib/docs/2019/january/tradoc_157631.pdf. See also Ondrej Svoboda, The EU and its Member States at the UNCITRAL: Pushing for the multilateral investment court against the odds, in: Isabelle Bosse-Platière, Cécile Rapoport and Nicolas Pigeon (eds), II LAwTTP Young Researchers Workshop "The New Generation of EU FTAs: External and Internal Challenges" LAwTTIP Working Papers 2019/6, pp 96-111.

new model also as problematic as it would still not allow for a participation of civil society organisations or enable claims against investors for the violation of human and labour rights and environmental standards[3].

In any case, focussing on the institutional and procedural elements of investment dispute settlement is insufficient, because a real and fundamental reform of the current system of investment protection will not be achieved as long as the substantial elements of investment protection agreements remain unchanged[4]. While the new EU model also contains some elements of reform with regards to the substance of investment agreements or investment protection chapters such as a modification of certain protection standards or the introduction of the so-called "right to regulate"-clause, the approach falls short of a real change as it builds on the traditional protection standards in international investment agreements such as "Fair and Equitable Treatment" (FET) which have been the source of many tensions between investment agreements and national regulatory autonomy and the maintenance of public policy space.

This study takes a different approach: It begins by asking on what normative grounds a foreign investor can legitimately raise a claim against the host state. As foreign investors compete with domestic investors and realise their profits on the domestic market, the starting point of any investment protection regime should be the attempt to protect competitive relations between domestic and foreign investors or among different foreign investors. However, foreign investors should not have the right to raise any substantial claims which domestic investors cannot raise. In addition, a foreign investor may legitimately claim compensation in the case of an expropriation as this is a standard of customary international law. Contemporary international investment treaties go beyond these basic considerations and contain rights which only foreign investors can claim, and which therefore privilege foreign over domestic investors[5].

Furthermore, the present proposal is based on the assumption that any obligation in an international investment agreement always limits the regulatory autonomy of a state. In fact, limiting the discretion of state power is the main purpose of international investment agreements. However, states need regulatory autonomy and policy space to achieve public goods and to protect the rights of individuals against corporate actors. It is therefore necessary that an international investment agreement contains elements which allow for a balance between the restrictions of the state autonomy and legitimate public purposes the state wishes to achieve through measures which might have a negative effect on foreign investors. The current debates about measures of EU Member States terminating fossil fuel-based energy production and potential claims by foreign investors aptly illustrate how traditional investment agreements, in particular the Energy Charter Treaty, may impede government measures aimed at a shift in energy policies to address the challenges of climate change[6].

[3] Gus Van Harten, A Parade of Reforms: The European Commission's Latest Proposal for ISDS (May 6, 2015). Osgoode Legal Studies Research Paper No. 21/2015, available at SSRN: https://ssrn.com/abstract=2603077.

[4] Rhea Tamara Hoffmann, The Multilateral Investment Court: A Stumbling Block for Comprehensive and Sustainable Investment Law Reform, European Society of International Law (ESIL) 2018 Annual Conference (Manchester), available at SSRN: https://ssrn.com/abstract=3363926.

[5] Ivar Alvik, The Justification of Privilege in International Investment Law: Preferential Treatment of Foreign Investors as a Problem of Legitimacy, 31 European Journal of International Law (2020), pp. 289–312.

[6] Kyla Tienhaara, Lise Johnson and Michael Burger, Valuing Fossil Fuel Assets in an Era of Climate Disruption, Investment Treaty News, 20 June 2020, available at https://www.iisd.org/itn/en/2020/06/20/valuing-fossil-fuel-assets-in-an-era-of-climate-disruption/

2. Main principles and objectives of reforming substantive provisions

The starting point of reformed provisions on substantive investor protection should be the acknowledgement that foreign investors compete with domestic investors on the market of the host state. In a world of global value chains[7] and increasing investment flows in all parts of the world[8], the traditional assumption that foreign investors need a different form of protection than domestic investors, because they face additional and special threats[9], is no longer accurate and cannot serve as a legitimizing factor for international investment agreements[10]. Furthermore, foreign investors do not need a special protection regime to reward them for the decision to invest in other countries, because investors typically base their decision to invest abroad on an expected return on their investment. In fact, empirical research has shown that investors base their investment decisions on a variety of factors such as the size of the relevant market, legal and political stability, labour costs, expected business opportunities and direct government subsidies. However, they often do not consider the protection of their investment through international investment law as a basis of their decision[11].

Hence, international investment treaties should not create a special protection regime for foreign investors and investors cannot legitimately expect that states "reward" them for investing in a foreign market by giving them more or a different protection than domestic investors. However, foreign investors can legitimately expect that they are generally not discriminated against and that they are being compensated in case of an expropriation. As a consequence, international investment agreements should aim at protecting the level playing field between domestic and foreign investors.

Based on this, the reform of international investment treaties requires substantive changes of the main elements of such treaties, not just reforming dispute settlement mechanisms or clarifying and further concretising substantive protection standards. Such clarification and further details for substantive standards may be helpful, but they do not solve the fundamental issues. Furthermore, it is argued that the problems associated with international investment law as it stands today are not primarily to be found in the arbitrators or the arbitration process, but in the substantive law they apply. To put it short: If investment treaties contain provisions which unjustifiably limit regulatory autonomy, it makes hardly any difference if such provisions are applied by an ad hoc arbitration panel or a permanent multilateral investment court.

In order to provide for a level playing field between foreign and domestic investors, the principle of non-discrimination should be the cornerstone of international investment agreements. Non-discrimination encompasses the most favoured nation treatment and national treatment. Even though these principles originate in international trade law, they have been part of international investment law since its beginnings. In one of the leading cases on national treatment in WTO jurisprudence, the WTO panel clearly pointed to the objective of national treatment when stating that the national treatment principle provides "equality of competitive conditions for imported products in relation to domestic products." [12]

[7] ~~WTO, Technical innovation,~~ supply chain trade, and workers in a globalized world, Global Value Chain Development Report 2019.

[8] Foreign direct investment continued to grow until the Covid 19-pandemic lead to a sharp decrease, see UNCTAD, International Production Beyond the Pandemic, World Investment Report 2020, p. 11.

[9] Sarah Bauerle Danzman, The political economy of bilateral investment treaties, in: Rhea Tamara Hoffmann/Markus Krajewski (eds) Research Handbook on Foreign Direct Investment, 2019, 11 (14-15).

[10] Generally see Alec Stone Sweet and Florian Grisel, The Evolution of International Arbitration - Judicialization, Governance, Legitimacy, 2017.

[11] See the references in Bauerle Danzman, above note, at 22.

[12] Japan — Alcoholic Beverages II, pp. 16–17, DSR 1996:I, 97, at 109–110

In addition, international investment agreements should contain an obligation to pay compensation in the case of an expropriation as this is a generally accepted standards of public international law and reflected in state practice. For example, both the United Nations Resolution on "Permanent sovereignty over natural resources"[13] and the UN Charter of Economic Rights and Duties of States[14] require that adequate compensation shall be paid if the investor was subject to expropriation.

3. Elements of a draft text

Limiting substantive protection standards. Based on the general objectives and principles established above the substantive provisions of an international investment agreement should only contain the standards of most favoured nation and national treatment as well as compensation for expropriation. The standard of expropriation is particularly problematic to the extent it also covers so-called regulatory takings, i.e. regulatory measures which are deemed to have the same effects as expropriation. The notion of indirect expropriation has been used to challenge measures of general and regulatory manner. However, the exact contours of indirect expropriation remain unclear and contested[15]. Regulatory expropriation denotes regulatory measures which generally aim (or are said to aim) at public interests but which deprive the investor of the commercial value of the investment. This notion makes the potential for conflict between investors' rights and regulatory autonomy clearly visible. Investment tribunals, in particular based on the investment chapter of the North American Free Trade Agreement (NAFTA) of 1992, have applied the standard of indirect expropriation broadly and used it to award investors compensations for environmental regulations. It is therefore vital that the standard of indirect expropriation is clearly and expressly limited to measures which are in essence an expropriation and does not cover legitimate regulations[16].

As a consequence of the objectives and principles laid out above, it is suggested that a reformed investment protection agreement or respective chapter on investment protection in a free trade agreement does not contain the protection standards of "fair and equitable treatment" (FET) as this is a substantive protection standard on which domestic investors cannot rely. Extensive interpretations of this standard in past investment arbitration awards turned this standard into a weapon against domestic laws and other regulatory measures. The most important element of this standard concerns the legitimate expectations of the investor[17] which can be based on the legal framework in general[18] or on the behaviour of officials[19]. Another important element of FET is the maintenance of a stable legal and business environment[20]. These interpretations include a presumption against changes and reform and are therefore especially problematic from the perspective of social and labour regulation. Regardless of its breath or narrowness, FET is necessarily a protection standard which provides a privilege to foreign investors. This is also the case for the standard of "full protection and security" which may be used to accuse states of not protecting investments against external threats such as strikes or protests. While contemporary practice of the

[13] GA Res. 1803 (XVII) of 14 December 1962.

[14] GA Res. 3281 (XXIX) of 12 December 1974.

[15] Técnicas Medioambientales Tecmed S.A, v. The United Mexican States, ICSID Case No. ARB (AF)/00/2, Award of 29 May 2003, para. 114.

[16] GA Res. 3281 (XXIX) of 12 December 1974.

[17] The investor's legitimate expectations are the "dominant element" of the fair and equitable treatment according to standard according to the tribunal in Saluka Investments B.V. v. Czech Republic, UNCITRAL Arbitration, Partial Award of 17 March 2006, para 304.

[18] CMS Gas Transmission Company v. Argentine Republic, ICSID Case No. ARB/01/8, Award of 12 May 2005, para 277.

[19] Metalclad Corporation v. United Mexican States, ICSID Case No. ARB(AF)/97/1, Award of 30 August 2000, paras 85 et seq.

[20] CMS Gas (fn. 23), para 274.

EU seeks to limit the effects of the FET standard by narrowing its scope, the fundamental root of the problem remains the same: Regardless of how narrowly defined the standard is, it will always be a standard which only applies to and therefore privileges foreign investors.

Minimising the "chilling effect" on regulations. Investment protection standards – regardless of how narrow they may be formulated - may have a chilling effect on regulations and therefore limit the regulatory autonomy of states. This is even the case with regards to the standards of non-discrimination, in particular national treatment. There may be in situations in which they may have legitimate reasons to distinguish between domestic and foreign investors or to adopt measures which have are of an indirect expropriation character. It is well-established and accepted in general international economic law that states may need some leeway for such differentiations. As a consequence, WTO law, but also the Treaty on Functioning of the European Union (TFEU) allow for exemptions from the standards of non-discrimination if such deviations can be justified.[21]

Many traditional bilateral investment treaties do not contain such a clause which leads to significant difficulties and challenges when the protection standards of these agreements are applied to legitimate state measures. Decades of jurisprudence of the dispute settlement bodies of the WTO as well as the European Court of Justice suggest, however, that such exemption clauses are an appropriate and useful tool to adequately balance legitimate state policy interests and the objectives of the protection of the free flow of trade and investment. Modern international investment treaties or investment protection chapters in free trade agreements such as CETA contain similar clauses.[22] It is therefore suggested that a reformed chapter on investment protection also contains such a general exception clause which however should extend to the protection of social and labour law, international environmental agreements and the protection and promotion of human rights.[23]

In its recent treaty practice, the EU also started to include a so-called "right to regulate" clause.[24] Through this clause the parties "reaffirm their right to regulate within their territories to achieve legitimate policy objectives, such as the protection of public health, safety, the environment or public morals, social or consumer protection or the promotion and protection of cultural diversity". However, "right to regulate" clauses are largely ineffective. To begin with, it should be noted that the clauses usually do not add any legal obligations or rights and are merely an interpretative tool. In other words, the clauses do not change the substantive rules of a trade and investment agreement.

Furthermore, "right to regulate" clauses are based on a flawed perception of the problem created by investment agreements. These agreements cannot and do not question or limit the "right" of states to regulate, which is an essential feature of the sovereignty of states. Instead, investment agreements limit the policy options and choices of states how to exercise the right to regulate, by excluding certain regulatory measures or putting them under pressure by requiring the state to pay compensation. It is hence not surprising that investment dispute settlement organs have repeatedly held that these agreements do not limit the right to regulate, but that states must exercise this right without violating the respective treaties. This shows that any reference to a right to regulate will be ineffective if the respective rules and obligations of investment agreements are not changed.

[21] See Articles XX GATT and XIV GATS on the one side and Articles 36, 52 (1) and 65 (1) (b) TFEU on the other.

[22] See Article 28.3.2 CETA.

[23] For a proposal of such a clause concerning human rights see Lorand Bartels, A Model Human Rights Clause for the EU's International Trade Agreements, German Institute for Human Rights, 2014.

[24] See e. g. Article 8.9.1 CETA

Limiting the definition of protected investments. Furthermore, the scope of the investment treaty should be limited to foreign investment which significantly contributes to the economy of the host state, and which consist of actual business activities including the transfer of assets. This would exclude minimal portfolio investments or so-called "letter-box" companies which do not engage in any meaningful economic activities, and which are sometimes only set up to obtain the benefits of an investment protection agreement. References should therefore be made to the requirement of a certain duration of the investment and the commitment of capital or other resources.

Including investors obligations. In addition, a reformed investment protection agreement should contain a provision containing substantive investor obligations based on internationally recognised standards of corporate responsibility such as the UN Guiding Principles on Business and Human Rights or the OECD Guidelines for Multinational Enterprises. Incorporating such investor obligations has been proposed in scholarly literature and by civil society. Investor obligations contribute to the rebalancing of investor rights and state obligations in international investment agreements. Including investor obligations in an investment treaty would also allow states to use these obligations as defences or as the basis for counterclaims. Some states have already begun to include such clauses in modernised investment agreements although the practice remains limited.[25] In this context, it is also worth considering the inclusion of a provision incorporating the so-called "clean hands"-doctrine. According to this doctrine, investors have only access to the dispute settlement proceedings in an investment treaty or chapter if they have not violated domestic law, substantive investor obligations established in the investmentagreement or elsewhere or other international standards applicable to companies.[26] The doctrine is considered a general principle of public international law and has been applied by some investment tribunals in the past. However, a revised investment treaty or chapter could specifically include such a provision to avoid any ambiguity. An explicit "clean hands"-doctrine would have to be part of the dispute settlement provisions of the investment treaty or chapter. As this is not covered in the present study, the proposed text does not include such an explicit clause.

4. Political Feasibility

While the proposal developed in this study would be a significant deviation from the current EU investment treaty practice, its main provisions are based on the language of existing treaty practice. It should also be noted that most international investment treaties still contain the FET standard. There are, however, some notable exceptions, including the Australia - China Free Trade Agreement of 2015 or the Brazil - Mexico Bilateral Investment Treaty of 2015 as well as other BITs of Brazil which are however not yet in force.

Nevertheless, the text suggested below would amount to a policy shift for the EU. It is argued that the time to institute such a policy shift is now better than before. First, the traditional investment regime is coming under additional pressure as investors have threatened arbitration proceedings against measures taken by states in reaction to the Covid-19 pandemic. Second, in light of the current debates about changing the Energy Charter Treaty the debate about the reform of international investment law, in particular its substantive elements, is prominently placed on the political agenda. Third, the planned agreement on investment protection and liberalisation between the EU and China raises high hopes for some businesses, but also produces many fears by critical observers and organisations, in particular in the EU. This further opens the space for a renewed debate on the reform of substantive standards of investment protection.

[25] Markus Krajewski, A Nightmare or a Noble Dream? Establishing Investor Obligations Through Treaty-Making and Treaty-Application, 5 Business and Human Rights Journal 2019, pp. 105-129.

[26] Patrick Dumberry and Gabrielle Dumas-Aubin, How to Impose Human Rights Obligations on Corporations Under Investment Treaties? 4 Yearbook on International Investment Law and Policy, 2011-2012, p. 569 at 589

ANNEX

DRAFT PROPOSAL FOR A TEXT FOR THE SUBSTANTIAL PROVISIONS OF AN INVESTMENT AGREEMENT OR CHAPTER

Article 1 - Scope of Application

1. This agreement shall apply to measures adopted or maintained by a Contracting Party in its territory relating to investors of the other Contracting Party and covered investments.

2. This agreement does not apply to measures relating to:

a) the rescheduling, restructuring, or conversion in any form of a debt issued by a Contracting Party including debts issued at central, regional and local governments (public debt);

b) the resolution or restructuring of a bank and other financial institution which is no longer viable or faces financial difficulties in accordance with the law applying to such resolution or restructuring;

c) audio-visual services and cultural industries;

d) subsidies or grants provided by a Contracting Party, including government-supported loans, guarantees and insurance;

e) taxation measures including measures implementing international taxation conventions and double taxation treaties; and

f) procurement by governmental agencies of goods and services purchased for governmental purposes and not with a view to commercial resale or with a view to use in the supply of goods or the supply of services for commercial sale and

g) activities carried out in the exercise of public authority.

Explanation

The scope of application of the agreement refers to measures affecting foreign investors and investments to the extent they are covered by the agreement and excludes a number of policy fields from the scope of the protection. The next article then defines the key terms of the scope. The proposed text follows the structure of CETA chapter 8 which also contains definitions (Article 8.1.) and a separate provision on the scope (Article 8.2.). Regarding the policy fields excluded from the scope of application, the proposed text includes the typical exclusions of EU investment agreements. Some of these exclusions such as the public debt exemption only apply to specific clauses of EU investment agreements (see Annex 8-B CETA) which may unduly limit their effectiveness. Hence, the present proposal applies this exclusion to the entire agreement. The proposed text also adds the exclusion of "activities carried out in the exercise of public authority" (lit. g) which can be found in agreements on trade in services and the TFEU. This clause provides for a carve-out for sectors which would typically be considered core governmental functions, including law enforcement, correction facilities and the administration of justice.

Article 2 - Definitions

For the purpose of this Agreement:

covered investment means, with respect to a Contracting Party, an investment:
in its territory;

a) made in accordance with the applicable law at that time;

c) directly owned or controlled by an investor of the other Contracting Party; and

d) existing on the date of entry into force of this Agreement, as well as investments made or acquired thereafter.

enterprise means any entity duly constituted or otherwise organized under the applicable law of a Contracting Party, whether for profit or otherwise, and whether privately-owned or controlled or governmentally owned or controlled, including any corporation, trust, partnership, joint venture, sole proprietorship or association and a branch or representative office of any such entity.

investment means:

Every kind of asset that an investor directly owns or controls that has the characteristics of an investment, which includes a certain duration and the commitment of capital or other resources, or the expectation of gain or profit, or the assumption of risk. Forms that an investment may take include:
an enterprise;

a) shares, stocks and other forms of equity participation in an enterprise;

c) bonds, debentures and other debt instruments of an enterprise;
a loan to an enterprise;

d) an interest arising from a turnkey, construction, production, or revenue-sharing contract, or other similar contracts;

f) intellectual property rights; or

g) any other moveable property, tangible or intangible, or immovable property and re lated rights.

Returns that are re-invested shall be treated as investments. Any alteration of the form in which assets are invested or reinvested does not affect their qualification as investment.

investor means a natural person or an enterprise of a Contracting Party, other than a branch or a representative office, that is making or has made an investment in the territory of the other Contracting Party.

For the purposes of this definition an 'enterprise of a Contracting Party' is:

a) an enterprise that is constituted or organised under the laws of that Contracting Party and has substantial business activities in the territory of that Contracting Party; or

b) an enterprise that is constituted or organised under the laws of that Contracting Party and is directly or indirectly owned or controlled by a natural person of that Contracting Party or by an enterprise mentioned under a).

For greater certainty, "substantial business activities in the territory of the Contracting Party" excludes activities of shell companies or companies solely holding shares of another company and requires such elements as a recognisable physical presence, actual economic activities in the

territory of the Contracting Party and a considerable number of employees in view of the actual economic activity of the enterprise.

For the purposes of this agreement an enterprise is:
(i) "owned" by an investor of a Contracting Party if more than 50 percent of the equity interests in it is owned by the investor;
(ii) "controlled" by an investor of a Contracting Party if the investor has the power to name a majority of its directors or otherwise to legally direct its actions.

natural person means

> a) in the case of X (…); and
>
> b) in the case of the EU, a natural person having the nationality of one of the Member States of the EU according to their respective legislation, and, for Latvia, also a natural person permanently residing in the Republic of Latvia who is not a citizen of the Republic of Latvia or any other state but who is entitled, under laws and regulations of the Republic of Latvia, to receive a non-citizen's passport.
>
> A natural person who is a citizen of X and has the nationality of one of the Member States of the EU shall be deemed to be exclusively a natural person of the Contracting Party of his or her dominant and effective nationality.
>
> A natural person who has the nationality of one of the Member States of the European Union or is a citizen of X, and is also a permanent resident of the other Contracting Party, shall be deemed to be exclusively a natural person of the Contracting Party of his or her nationality or citizenship, as applicable.

returns means all amounts yielded by an investment or reinvestment, including profits, royalties and interest or other fees and payments in kind.

Explanation

The definition of the terms „investment" and „investor" are key elements determining the scope of an investment agreement or investment protection chapter and therefore also determine the balance between investment protection and achieving public policy objectives.

The present proposal is based on language of CETA but contains a number of important modifications. It adopts a closed list for the term "investment" and excludes problematic elements to be found in some agreements such as concessions or claims for money which may not necessarily result from an investment, but could also be purely contractual. A closed list is usually considered a useful instrument to maintain regulatory autonomy while protecting those kinds of investment which are based on real business activities.

The text also proposes that the agreement would only apply to existing investment made in accordance with the applicable domestic law. As a consequence, the agreement does not protect the right to establishment or the so-called pre-establishment phase. This means, that the EU, its Member States and the other Contracting Party maintain the right to screen investment and also reject investors the right to establish themselves without violating the terms of the agreement. The agreement only provides protection after the investment has been established in accordance with the domestic law (so-called post-establishment phase).

Concerning the definition of an investor, the text excludes the other Party as investor. In other words, the state parties to the agreement themselves cannot be considered as investors. This means that a state-owned enterprise would only be protected under the agreement if it is a separate legal entity from the state which owns the company.

Finally, the proposed text also states that companies are only protected under the agreement if they engage in substantial business activities thus excluding shell or so-called letterbox companies. The definition of the term „substantial business activities" is based on Pac Rim v El Salvador (ICSID Case No. ARB/09/12), Decision on the Respondent's Jurisdictional Objections, 1 June 2012, para. 4.72.

Article 3 - National Treatment

1. Each Contracting Party shall accord to investors of the other Contracting Party and to covered investments, treatment no less favourable than the treatment it accords, in like situations to its own investors and to their investments with respect to the conduct, operation, management, maintenance, use, enjoyment and sale or disposal of their investments in its territory. For greater certainty, this includes quantitative expansions of the production or service capacity in respect of a covered investment, provided that such expansions relate to the same product or service which has been approved or licensed by the host state as a permissible investment in accordance with domestic law and this Treaty at the time of establishment.

2. The treatment accorded by a Contracting Party under paragraph 1 means, with respect to a government in X other than at the federal level, or, with respect to a government of or in a European Member State, treatment no less favourable than the most favourable treatment accorded, in like situations, by that government to investors of that Contracting Party in its territory and to investments of such investors.

3. For greater certainty, treatment accorded by the Member States of the European Union under paragraph 1 does not extend to nationals or juridical persons of the other Party the treatment granted in a Member State to the nationals and juridical persons of another Member State of the European Union pursuant to the Treaty on the Functioning of the European Union, or to any measure adopted pursuant to that Treaty, including their implementation in the Member States. Such treatment is granted only to legal persons of the other Party established in accordance with the law of another Member State and having their registered office, central administration or principal place of business in that Member State, including those legal persons established within the EU which are owned or controlled by nationals of the other Party.

4. For greater certainty, a measure distinguishing between investors based on the private or public nature of their ownership shall not be considered treatment less favourable in the meaning of paragraph 1.

Explanation

The provision on national treatment provides for the non-discriminatory treatment between domestic and foreign investors. It is therefore the key provision aimed at maintaining the level playing field. Paragraphs 1 and 2 of this provision are based on Article 8.6.1 and 8.6.2 CETA, but do not cover the "establishment" of the investor in accordance with the restricted scope as established in Article 2 of this proposal. Paragraph 1 of this Article clarifies that quantitative expansions of the production or service capacity in respect of a covered investment is protected and would not be considered a new establishment. Paragraph 3 maintains the right of the Member States to treat investors which are established in the EU differently than investors established elsewhere. As a consequence, an investor would have to establish itself through the laws of an EU Member State. Paragraph 4 suggests a clause clarifying that the parties to the agreement may distinguish between public companies which are often discharged with public utilities and services of general interest.

Article 4 - Most-Favoured-Nation Treatment

1. Each Contracting Party shall accord to investors of the other Contracting Party and to covered investments, treatment no less favourable than the treatment it accords in like situations to investors and to their investments of any third country with respect to the conduct, the operation, management, maintenance, use, enjoyment and sale or disposal of their investments in its territory. For greater certainty, this includes quantitative expansions of the production or service capacity in respect of a covered investment, provided that such expansions relate to the same product or service which has been approved or licensed by the host state as a permissible investment in accordance with domestic law and this Treaty at the time of establishment.

2. For greater certainty, the treatment accorded by a Contracting Party under paragraph 1 means, with respect to a government in X other than at the federal level, or, with respect to a government of or in a European Member State, treatment accorded, in like situations, by that government to investors in its territory, and to investments of such investors, of any third country.

3. Paragraph 1 shall not apply to treatment accorded by a Contracting Party providing for recognition, including through arrangements or agreements with third parties, recognising accreditation of testing and analysis services and service suppliers or repair and maintenance services and service suppliers, as well as the certification of the qualifications of or the results or work done by such accredited services and service suppliers.

4. For greater certainty, the "treatment" referred to in Paragraph 1 and 2 does not include substantive obligations and investor-to-state dispute settlement procedures provided for in other international investment treaties and other trade agreements including agreements establishing a regional economic integration organisation.

Explanation

The proposed text modifies the MFN-clause in CETA (Article 8.7). Like Article 3 in the proposed text, it only covers investors and investments which are already established and maintains the clarification for the expansion of existing businesses. It also allows a deviation if a party to the investment agreement concluded an agreement on mutual recognition with a third state. This deviation would limit potential free-rider effects for a state which is not party to that agreement. Finally, and importantly, paragraph 4 excludes the application of the MFN clause to standards to be found in other investment protection agreement. In light of many existing old BITs of EU Member States this ensures that an investor cannot rely on the broader and more investor-friendly provisions of these agreements and incorporate them into the present agreement through the MFN-clause. While CETA limits this mechanism to investor-state dispute settlement, it is vital that the current text extends to substantive obligations as it contains a more limited scope of investor protection than older BITs. Without the clause in paragraph 4 investors may rely on other agreements and circumvent the limiting effects of this proposal.

Article 5 - Expropriation

1. Neither Contracting Party may nationalize or expropriate a covered investment either directly, or indirectly through measures having an effect equivalent to nationalization or expropriation (hereinafter referred to as "expropriation"), except:
for a public purpose;

a) under due process of law;

b) in a non-discriminatory manner; and

d) against payment of prompt, adequate and effective compensation.

For greater certainty, this paragraph shall be interpreted in accordance with the Annex on the clarification of expropriation.

2. Such compensation shall amount to the fair market value of the investment at the time immediately before the expropriation or the impending expropriation became known, whichever is earlier. Valuation criteria shall include going concern value, asset value, including the declared tax value of tangible property, and other criteria, as appropriate, to determine fair market value.

3. The compensation shall also include interest at a normal commercial rate from the date of expropriation until the date of payment and shall, in order to be effective for the investor, be paid and made transferable, without delay, to the country designated by the investor and in the currency of the country of which the investor is a national or in any freely convertible currency accepted by the investor.

4. The investor affected shall have a right, under the law of the expropriating Contracting Party, to prompt review of its claim and of the valuation of its investment, by a judicial or other independent authority of that Contracting Party, in accordance with the principles set out in this Article.

5. This Article does not apply to the issuance of compulsory licenses granted in relation to intellectual property rights, to the extent that such issuance is consistent with the Agreement on Trade-Related Aspects of Intellectual Property Rights in Annex 1C to the WTO Agreements (TRIPS).

6. For greater certainty, the revocation, limitation or creation of intellectual property rights, to the extent that these measures are consistent with TRIPS, do not constitute expropriation. Moreover, a determination that these actions are inconsistent with the TRIPS Agreement does not establish that there has been an expropriation.

7. For greater certainty, a Contracting Party's decision not to issue, renew or maintain a subsidy or grant,

(a) in the absence of any specific commitment under law or contract to issue, renew, or maintain that subsidy or grant; or
(b) in accordance with any terms or conditions attached to the issuance, renewal or maintenance of the subsidy or grant shall not constitute an expropriation.

Annex on the clarification of expropriation

The Contracting Parties confirm their shared understanding that:

1. Expropriation may be either direct or indirect:

> a) direct expropriation occurs when an investment is nationalised or otherwise directly expropriated through formal transfer of title or outright seizure; and
>
> b) indirect expropriation occurs where a measure or series of measures of a Contracting Party has an effect equivalent to direct expropriation, in that it substantially deprives the investor of the fundamental attributes of property in its investment, including the right to use, enjoy and dispose of its investment, without formal transfer of title or outright seizure.

2. The determination of whether a measure or series of measures of a Contracting Party, in a specific fact situation, constitutes an indirect expropriation requires a case-by-case, fact-based inquiry that considers:

> a) the economic impact of the measure or series of measures, although the sole fact that a measure or series of measures of a Contracting Party has an adverse effect on the economic value of an investment does not establish that an indirect expropriation has occurred;
>
> b) the duration of the measure or series of measures by a Contracting Party; and
>
> c) the character of the measure or series of measures, notably their object, context and intent.

3. For greater certainty, non-discriminatory measures of a Contracting Party that are designed and applied to protect public welfare objectives, such as protecting health, safety, labour and social policies, consumer protection, the environment, cultural and linguistic diversity, media freedom and pluralism, do not constitute indirect expropriations by themselves.

Explanation

As explained in the main text of this study, compensation for expropriation is an established principle of international economic law. While this is mostly uncontroversial for direct expropriations, many debates and tensions concern the scope of indirect expropriation. Once again, it seems justifiably to include the general possibility of indirect expropriation to ensure that states do not circumvent their obligation by some form of factual expropriation. However, it seems important to limit the notion of indirect expropriation to rare situations which are indeed tantamount to a direct expropriation. This is necessary to avoid an overly broad interpretation and application of the standard which has been used in the past to challenge regulatory policies and regulations, in particular in the area of environmental protection. The present proposal is based on the text in Article 8.12. and Annex 8-A CETA, but excludes two problematic aspects of these provisions.

First, while CETA Annex 8-A includes "the extent to which the measure or series of measures interferes with distinct, reasonable investment-backed expectations" as one element to consider whether a measure amounts to an indirect expropriation, the present text (No 2 of the Annex) excludes this notion because references to legitimate or other expectations of investors have been used by investment panels to interpret the terms of the agreement broadly and therefore placed pressure on regulatory autonomy.

Second, No. 3 of the Annex in the present proposal which generally excludes non-discriminatory regulatory measures from the definition of "indirect expropriation" does not allow for the possibility that these measures can "in rare circumstances" nevertheless be considered as indirect expropriation as Annex 8-A of CETA suggests.

Article 6 – Investor obligations

Enterprises operating within the territories or subject to the jurisdictions of the Contracting Parties shall respect internationally recognized standards and principles of corporate social responsibility, which have been endorsed by the Contracting Parties, including the OECD Guidelines for Multinational Enterprises and the United Nations Guiding Principles on Business and Human Rights.

Explanation

The proposal of a clause containing investor obligations is based on similar proposals which can be found in the literature and in contributions of civil society. It would continue a development which started with some modern international investment agreements which already contain such clauses. This proposal refers to the two most commonly used international frameworks of corporate responsibility which are known to and used by many companies.

Article 7 - General exceptions

Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination nothing in this Agreement shall be construed to prevent the adoption or enforcement of measures by a Contracting Party necessary:

a) to protect public security or to maintain public order only, but only where a genuine and sufficiently serious threat is posed to one of the fundamental interests of society

b) to protect human, animal or plant life or health, including environmental measures;

c) to protect social and labour laws and collective bargaining agreements;

d) to implement obligations arising from human rights treaties and environmental agreements;

e) to preserve the diversity of cultural expressions;

f) for the conservation of living or non-living exhaustible natural resources; and

g) to secure compliance with laws or regulations including those relating to:
(i) the prevention of deceptive and fraudulent practices or to deal with the effects of a default on contracts;
(ii) the protection of the privacy of individuals in relation to the processing and dissemination of personal data and the protection of confidentiality of individual records and accounts;
(iii) safety.

Explanation

As pointed out above, a general exception clause is vital to allow states to justify measures which would otherwise violate the agreement. The present proposal is based on existing language in particular GATT, GATS and CETA, but adds three very important clauses allowing for the protection of domestic social and labour standards including collective bargaining agreements, the implementation of obligations arising from human rights treaties and environmental agreements and the preservation of the diversity of cultural expressions. These proposals are based on texts suggested in the literature and contributions by civil society.

60 rue Wiertz/Wiertzstraat 60
1047 Brussels, Belgium
www.greens-efa.eu
contactgreens@ep.europa.eu