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Notes on the German Economy and Energy Ministry's Proposal for Reformed Investor-State Dispute Settlement

Gus Van Harten

Abstract:

These notes provide a general reaction to a proposal by the German economy and energy ministry for ISDS in a treaty between Europe and the U.S. Overall, the proposal takes only a minority of the steps needed to make ISDS independent, fair, open, subsidiary, and balanced. I suggest that the appropriate approach remains to reject ISDS in new treaties (especially among Western developed countries). The proposal would be a good starting point for replacing ISDS in existing treaties with developing or transition countries – but that is clearly not its purpose.

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For Reformed Investor-State Dispute Settlement (ISDS)

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These notes provide a general reaction to a proposal by the German economy and energy ministry for ISDS in a treaty between Europe and the U.S. (the "Model bilateral investment treaty with investor-state dispute settlement for industrial countries, giving consideration to the U.S.; Project No. 83/15 of the Federal Ministry of Economic Affairs and Energy of Germany).

Overall, the proposal takes only a minority of the steps needed to make ISDS independent, fair, open, subsidiary, and balanced. I suggest the appropriate approach remains to reject ISDS in the Europe-U.S. Transatlantic Trade and Investment Partnership (TTIP), Canada-Europe Comprehensive and Economic Trade Agreement (CETA), and other new treaties (especially among Western developed countries). The German ministry's proposal would be a good starting point for replacing ISDS in *existing* treaties – but that is clearly not its purpose.

A. Context

ISDS can be contemplated in three contexts.

1. Existing treaties that provide for a (flawed) system of ISDS arbitration. Virtually all of these treaties are in the circumstances of relations (a) between Western developed and developing/ transition countries or (b) among developing/ transition countries.

2. New treaties in the same circumstances.

3. New treaties among Western developed countries. The only such treaties that exist now are the North American Free Trade Agreement and the Energy Charter treaty, both of which date from 1994. Notably, these two treaties have generated well over 100 foreign investor lawsuits, indicating that if more such treaties are concluded, they would

likely increase foreign investor lawsuits dramatically. The key treaties now being pushed are the Canada-EU CETA, the EU-US TTIP, and the US-led Trans-Pacific Partnership (TPP).

B. Fitting the proposal within this context

The German Ministry's model is designed for situation 3 above. Thus, it is proposed in the context least suited for ISDS: relations among developed countries with established democracies and independent court systems. In turn, the minimum criteria for ISDS are all the more critical in this context.

C. Criteria

For ISDS to be acceptable, it must at least be:

- independent, fair, and open—in its institutional structure and process;
- subsidiary—in its relationship to other democratic, governmental, and adjudicative institutions;
- balanced—in its accounting for (a) the state's right to regulate alongside foreign investor protections and for (b) foreign investor rights and responsibilities.

I suggest that these criteria are broadly consistent with the democratic constitutional order put in place in the post-war period in Europe and otherwise existing in North America. Thus, the criteria should be treated as the *minimum* criteria for an ISDS proposal at the international level that does not undermine the idea of a democratic constitutional order in which people can elect a political leadership to form a government that is capable of implementing social and economic reforms, subject to judicial protections of everyone's fundamental rights.

By *independent*, I mean an ISDS process that is fully judicial in the manner of a court. By *fair*, I mean an ISDS process that provides a right of standing to all affected parties in the process, including public notice of disputes once they are filed in order to allow

other affected parties to apply for standing. By *open*, I mean an ISDS process that is public in the manner of an open court.

By *subsidiary*, I mean a requirement that foreign investors must exhaust domestic remedies, that ISDS judges must not proceed in parallel to domestic or contractually-agreed forums, and that ISDS judges should defer to democratically-accountable legislators or expert regulators who face policy questions not well-suited for adjudication.

By *balanced*, I mean the inclusion of a clear affirmation of the state's substantive right to regulate, the provision for foreign investor responsibilities that are actionable in the same manner as foreign investor rights, and the moderation of the remedy so that states are not crippled in their law-making and regulatory functions by the uncertainty of potentially massive financial liability.

I stress that, in the present context of relations among Western developed countries, the case for ISDS may still not be established, even if all of these criteria have been met. That is, states may still consider that the threat to democratic choice, judicial independence, regulatory flexibility, and public budgets too high in comparison to whatever public benefit is thought to come from privileging and subsidizing foreign investors through ISDS.

D. Fitting the proposal into this list of criteria

The German Ministry's proposal refers to these areas of reform:

- Protection of the state's right to regulate;
- Establishment of a dispute-settlement procedure which meets the requirements of the rule of law;
- Clarification of the relationship between domestic legal protection and ISDS; and
- Review of the decisions of the ISDS mechanisms by a second instance.

These areas of reform have the *potential* to deliver on *some* of the criteria above.

With respect to independence, fairness, and openness, each of these criteria could possibly be met within the area of dispute settlement that “meets the requirements of the rule of law”. With respect to subsidiarity, this criterion could possibly be met *only in part* within the areas of “the relationship between domestic legal protection and ISDS” and provision for review by “a second instance” body. With respect to balance, this criterion could be met *only in part* by the protection of “the right to regulate”.

Even for the criteria that could be met within the areas of reform, it is necessary to review a legal text of an agreement before one can say whether the criteria have been met. In the absence of a legal text, any commitment to “reform” is essentially meaningless, from a legal point of view.

E. Evaluation of the text laid out in the proposal

1. *Criterion of judicial independence*

Positive aspects:

- The proposal anticipates the creation of a permanent investment tribunal. The tribunal members would be state-appointed and would have *some* safeguards of judicial independence, especially a (short) tenure of four years and an objective method of case assignment. Also, members of the tribunal would be chosen by states, instead of one being chosen by the foreign investor and the presiding member being subject to agreement by the foreign investor. It is unclear whether tribunal members would be paid a set salary.
- The proposal offers a signal that persons other than the usual crowd of ISDS arbitrators may be appointed as the tribunal members. In particular, it requires members to have expertise in both international law and domestic public law (Article 19(3)). [Please note: An earlier version of these Notes erroneously stated that the proposal did not require expertise in public law and identified this aspect of the proposal as negative. In light of the requirement for expertise in domestic

public law, this aspect has been changed to an additional positive aspect on the criterion of independence].

Negative aspects:

- The proposal implies (in Article 22) that the tribunal members would be able to work on the side as ISDS lawyers (during, before, or after their service on the tribunal). Such double-dipping is fundamentally incompatible with judicial independence and a major issue in the current system of ISDS.
- It would be preferable if the proposal blocked those who have worked as ISDS lawyer/ arbitrators in the previous, say, five years from being appointed to the tribunal. It would be unfortunate if the same key group of persons who have taken ISDS in such an adventurous direction in the past 15 years were to populate or even dominate a permanent tribunal.

2. Criterion of fair process

Positive aspects:

- Nothing significant.

Negative aspects:

- While the proposal envisions that the permanent tribunal would develop rules of procedure, it does not include any provision for notice and standing rights to parties directly affected by the dispute, other than the foreign investor and national government.

3. Criterion of openness

Positive aspects:

- The proposal would adopt a broadly open process.

Negative aspects:

- The proposal would still allow for confidential settlements prior to the filing of formal documents. Ideally, there should be a requirement and process for public reporting of all changes to government decisions or pay-outs of public money that are linked to ISDS, even before a formal document is filed. It should also be required that the terms of any ISDS-related settlement be public.
- From the discussion of independence and fairness above, the proposal does not subject the determination of whether documents should be kept confidential to a judicial process.

4. Criterion of subsidiarity

Positive aspects:

- Nothing significant.

Negative aspects:

- The proposal does not require the exhaustion of local remedies. Instead, it provides this as one alternative. The other alternative is for the investor to be able to sue in ISDS after waiving its right to go to domestic courts.
- This latter alternative does not provide for subsidiarity in relation to domestic courts. Instead, it establishes a special, powerful tribunal for foreign investors only. This approach would not be viable in an international process that allows for broad-ranging claims by and against foreign investors. It gives foreign investors a privilege not available for anyone else in international law, even though the international legal protections available to everyone else are far weaker than those available to foreign investors in ISDS.
- The proposal does not require ISDS judges to stay their proceedings in the face of a contractually-agreed forum.

- The proposal does not require ISDS judges to defer to democratically-accountable legislators or expert regulators who face policy questions not well-suited for adjudication.

5. *Criterion of balance*

Positive aspects:

- The proposal suggests that foreign investor rights beyond national treatment and most-favoured-nation treatment should be removed from the treaty. This would ameliorate to a degree the current imbalance arising from the provision for wide-ranging foreign investor rights without an affirmation of the state's right to regulate. Unfortunately, this aspect of the proposal is only a suggestion.
- The proposal limits the payment of compensation to direct losses and excludes lost future profits. This approach reduces the state's risk of financial damage associated with the treaty's uncertainty. However, it leaves open important aspects of that risk. There are other important ways to ameliorate the risk in order to preserve democratic choice, regulatory flexibility, judicial finality, and public budgets.

Negative aspects:

- The proposal affirms the right to regulate only in the preamble. It does not include a clear affirmation of the right to regulate, as a general substantive right of the state, in the text of the treaty itself.
- Instead, the treaty text relies on exceptions to protect some of the state's activities (and even these exceptions are undermined, e.g. by the use of the word "prevent" which allows for an order of full compensation on the basis that such an order does not prevent the state's measure). Overall, foreign investor protections are not balanced against the right to regulate. Rather, they are prioritized over the right to regulate.

- The proposal does not place any binding and actionable responsibilities on foreign investors. It refers to foreign investor responsibilities only in aspirational terms (in Article 11).

F. Conclusion

The proposal does not ensure an independent and fair process of ISDS. It goes part-way to the establishment of an independent judicial body, but allows for that body to be dominated by ISDS lawyers who would have a similar range of conflicts of interests as ISDS arbitrators currently do. The proposal does not provide for a basically fair process by ensuring standing for all affected parties in the dispute.

The proposal takes meaningful steps toward an open process of ISDS, but leaves in place the prospect of secret settlements involving changes to government decisions or public pay-outs that privilege foreign investors.

The proposal fails to ensure the subsidiarity of ISDS. It does not commit to subsidiarity in relation to domestic courts. It does not take any steps to ensure subsidiarity based on deference to contractually-agreed forums, elected legislatures, and expert regulators.

The proposal includes a positive element to limit the scope of the remedy by excluding lost profits from the amount of compensation. The proposal does not otherwise protect the right to regulate in a meaningful way. The proposal also does not envision any actionable responsibilities for foreign investors.

While the proposal has positive elements, overall it is a big step back from the straightforward and commendable position: ISDS has no place in a treaty between established democracies with independent court systems. A compelling case has not been made for special privileging of foreign investors in this context. I suggest that the appropriate approach remains to reject ISDS in CETA and TIPA and to shift the German Ministry's proposal to the context of replacing ISDS in existing treaties.