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The Proposed Investor-State Dispute Settlement (ISDS) Mechanism: U.S. Should Oppose EU Demand to Abandon It

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One of the most important components of the proposed Transatlantic Trade and Investment Partnership (TTIP) between the United States and the European Union is the establishment of a mechanism for investor-state dispute settlement (ISDS). An appropriately structured ISDS is an essential part of trade agreement enforcement and should be included in any comprehensive U.S. trade agreement with the EU.

The EU's proposal, backed by a vote of the European Parliament on July 8—that the TTIP should establish a permanent investment court, not an ISDS mechanism—is a bad solution in search of a non-existent problem. ISDS mechanisms work well to secure basic legal protections for a signatory state's nationals abroad. The U.S. should firmly reject the EU's proposal and insist that TTIP establish an ISDS.

ISDS Advantages

ISDS mechanisms are commonly used to secure minimum standards of treatment, due process, non-discrimination, and full protection and security against expropriation for foreign investors. They can be structured to supplement domestic legal systems by requiring investors to exhaust their remedies in these systems first.[1] They are designed to safeguard fair, unbiased, and transparent legal processes by providing independent and impartial arbitration.

Such arbitration is part of the World Trade Organization (WTO), and of many bilateral and multilateral treaties to which the U.S. and the various EU member states are signatories. Agreements containing ISDS mechanisms protect the rights of governments to regulate in the public interest—including on public health and the environment—so long as they do so without discrimination and do not expose national, state, or local governments to new liabilities, procedures, or penalties that are not already available against them under domestic law.[2]

Observers such as Pascal Lamy, a former EU Trade Commissioner and current head of the WTO, have argued that an ISDS mechanism is not needed in a trade agreement between advanced industrial democracies with well-established legal systems.[3] The implication is that the EU, and its court system, does not discriminate against foreign firms and investors.

But in April, the EU's Digital Commissioner, Günther Oettinger, called publicly on the EU to use regulations to discriminate against U.S. firms such as Apple, Amazon, and Google, in favor of "standards with a significant contribution from European industry." Statements like this make it clear that the EU will seek to regulate against the U.S. and that an ISDS is therefore essential.[4]

More broadly, because any case inside the EU can ultimately reach the European Court of Justice (ECJ), and the ECJ is mandated to make decisions

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that promote deeper European integration, it is not clear how the U.S. can rely on the ECJ to rule fairly when the EU seeks to promote integration in ways that discriminate against the U.S.

The Problems with the EU's Proposed International Court

The left in Europe, and to an extent in the U.S., has inaccurately criticized ISDS mechanisms, which are already widely used inside the EU. In order to meet these criticisms, the European Commission has proposed that TTIP should "transform the [ISDS] system towards one which functions more like traditional courts systems," with an appellate mechanism and tenured judges, and with the ultimate goal of establishing a multilateral international investment court.[5] EU Commissioner for Trade Cecilia Malmström states that the goal of these changes is to "rebalance the rights of the state and the investor in favor of the state."[6]

For the following seven reasons, the EU's proposal is a bad solution in search of a non-existent problem:

1. **An investment court would consolidate the diffuse powers of various ad hoc and temporary investment tribunals to create an empowered world court charged with overseeing nearly $2.64 trillion in foreign direct investments.** It would have limited accountability and few checks and balances. Today, ISDS panels are dissolved after reaching a decision, precisely in order to prevent them from being too powerful. A permanent, supreme investment court would be an imperial judiciary.

2. **An investment court will subordinate sovereign governments' own judiciaries.** Instead of supplementing domestic tribunals, a permanent court will replace them.

3. **An investment court will imperil the autonomy of national signatories.** In ISDS mechanisms, all parties (including investors) choose their arbitrators, either directly or indirectly, and the state parties in addition select the arbitration forum by negotiating and agreeing to the ISDS provisions. By contrast, in the investment court, there would be a standing body of judges subject to the collective approval of all the national authorities that negotiated the treaty, and only those authorities.

4. **The investment court's membership and jurisprudence would tend to increase the disparity between the more powerful and the less powerful nations, because all national parties would have a veto on the roster of judges.** This would diminish the leverage that poorer countries, with fewer plausible judges to pick from, could exercise.

5. **The EU's proposal structurally minimizes the role of the individual claimant as well as the state party.** It will resurrect the

1. See, for instance, *Apotex Holdings Inc. and Apotex Inc. v. United States of America*, ICSID Case No. ARB(AF)/12/1, Award on Jurisdiction and Admissibility, paras. 257 et seq. (June 14, 2013).
2. Ted R. Bromund, James M. Roberts, and Riddhi Dasgupta, "Investor-State Dispute Settlement (ISDS) Mechanisms: An Important Feature of High-Quality Trade Agreements," Heritage Foundation *Issue Brief* No. 4351, February 20, 2015, http://www.heritage.org/research/reports/2015/02/investor-state-dispute-settlement-isds-mechanisms-an-important-feature-of-high-quality-trade-agreements.
3. Benjamin Fox, "'Scaremongering' Threatens Trade Deal, U.S. Ambassador Warns MEPs," *EUObserver*, September 4, 2014, https://euobserver.com/news/125459 (accessed July 7, 2015). The European Parliament has advanced a similar argument: "Draft Report Containing the European Parliament's Recommendations to the Commission on the Negotiations for the Transatlantic Trade and Investment Partnership (TTIP)," European Parliament, Committee on International Trade, February 5, 2015, http://www.europarl.europa.eu/meetdocs/2014_2019/documents/inta/pr/1049/1049287/1049287en.pdf (accessed July 7, 2015).
4. Tom Fairless, "EU Digital Chief Urges Regulation to Nurture European Internet Platforms," *The Wall Street Journal*, April 14, 2015, http://www.wsj.com/articles/eu-digital-chief-urges-regulation-to-nurture-european-internet-platforms-1429009201 (accessed July 7, 2015).
5. "Investment in TTIP and Beyond—the Path for Reform," European Commission, May 5, 2015, http://trade.ec.europa.eu/doclib/docs/2015/may/tradoc_153408.PDF (accessed July 7, 2015).
6. Cecilia Malmström, "Investments in TTIP and Beyond—Towards an International Investment Court," European Commission, May 5, 2015, https://ec.europa.eu/commission/2014-2019/malmstrom/blog/investments-ttip-and-beyond-towards-international-investment-court_en (accessed July 7, 2015).

essence of the discredited diplomatic-espousal regime. Under the diplomatic-espousal doctrine, a claimant's suit against another nation could not proceed unless the claimant's home nation backed up the claimant. This led to horse-trading among nations to the disadvantage of claimants. An investment court with judges vetted by national parties would make it difficult for both nations and claimants to choose their arbiters.

6. **An investment court might not create predictable *stare decisis* (respect for precedent) that would help govern investor and national behavior.** It is true that the current ad hoc ISDS system has no formal system of precedents. But like many courts, the investment court would likely be governed by pragmatism and would overrule or disregard precedents when they were inconvenient. Far from establishing clear precedents, this would exacerbate confusion, unpredictability and instability, inflict delays, and increase costs.

7. **The current ISDS system of persuasive *stare decisis* is working well.** ISDS awards tend to be consistent with one another, and leading jurists have suggested[7] that an ISDS award, like a domestic decision, is more likely to be perceived as legitimate if the theory supporting it has the imprimatur of well-regarded experts.

What the U.S. Should Do

An ISDS is only necessary because the U.S. and the EU are negotiating a comprehensive trade agreement. If the U.S. and EU simply eliminated their tariffs and quotas and recognized each other's standards in a few high-value areas (such as automobiles and pharmaceuticals), they would not need an ISDS. The U.S. should vigorously pursue this free trade agenda with nations outside the EU, and with current EU members, such as the U.K., if and when they exit the European Union.[8]

Such agreements would be faster to negotiate, and would not create a framework leading to a costly harmonization of international regulations that would benefit today's vested interests at the expense of tomorrow's innovative ideas. Unfortunately, the U.S. and the EU have chosen the path of a comprehensive agreement: An ISDS is therefore necessary, especially as the EU, and EU courts, cannot be relied upon to regulate and decide fairly.

The operation of ISDS mechanisms can certainly be improved. By their very nature, arbitration decisions are not completely predictable. But if national parties wish to make the ISDS system more predictable, the text of the agreement establishing the ISDS should be specific about the governing interpretive methodology that the ISDS is to apply.

It is also possible that modest changes in the structure of the ISDS system would make it work better. There is room for the U.S. to consider in its negotiations with the EU how arbitrators are selected, how many arbitrators are required on each panel, and how the ISDS system can continue to promote bias-free arbitration that is responsive to precedent. But the EU's proposal does not seek to reform the ISDS system: The EU seeks to reject it.

The EU is advancing this proposal in a futile and wrong-headed effort to win over critics who are fundamentally skeptical about freer trade. These critics had not previously raised any objections to the many ISDS mechanisms to which EU nations are already party: They began to complain *only when* the U.S. became involved. That timing is telling. These opponents of ISDS mechanisms also assert that these mechanisms have "cost governments a lot of money," and avowedly seek to abolish ISDS mechanisms in order to weaken property rights.[9] That is the best reason of all for the U.S. to reject the EU's proposal.

7. Susan D. Franck, "The Legitimacy Crisis in Investment Treaty Arbitration: Privatizing Public International Law Through Inconsistent Decisions," *Fordham Law Review* Vol. 73, No. 4 (2005), pp. 1521–1625, and Jutta Brunnée and Stephen J. Toope, *Legitimacy and Legality in International Law: An Interactional Account* (Cambridge University Press, 2010), pp. 52–53.
8. Ted R. Bromund and Nile Gardiner, "Freedom from the EU: Why Britain and the U.S. Should Pursue a U.S.–U.K. Free Trade Area," Heritage Foundation *Backgrounder* No. 2951, September 26, 2014, http://www.heritage.org/research/reports/2014/09/freedom-from-the-eu-why-britain-and-the-us-should-pursue-a-usuk-free-trade-area.
9. Fox, "'Scaremongering' Threatens Trade Deal, U.S. Ambassador Warns MEPs."

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