

# ISDS and sovereignty

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The use of investor-state dispute settlement mechanisms in trade agreements and their impact on national sovereignty

NZIER report to Export New Zealand  
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# ISDS and sovereignty

With the Trans-Pacific Partnership (TPP) trade agreement negotiations in their final phase, much attention has been given to the issue of Investor State Dispute Settlement (ISDS) and the threat it allegedly poses to New Zealand’s sovereign right to pass laws to protect its citizens and environment. This report answers a few of the most commonly asked questions about ISDS.

We conclude that concerns over ISDS in TPP are often over-stated. ISDS is not a new concept for New Zealand, and we have negotiated ISDS clauses many times before without ill effects. Unless New Zealand negotiators sign up to an ISDS chapter that doesn’t include the safeguards that exist in our other international agreements, then our ability to regulate sensibly and transparently in the public interest should not be imperilled.

## What is ISDS?

ISDS forms an important part of Bilateral Investment Treaties (BITs) or Free Trade Agreements (FTAs) which have investment chapters. These agreements aim to facilitate trade and investment between countries.

ISDS gives foreign investors the ability to seek arbitration when they believe their rights under these agreements have been breached by a host government, and when attempts to settle disputes amicably have failed. Arbitration claims are focused on determining whether a breach causing damage has occurred, and if so, whether compensation should be awarded.

ISDS relates to investment aspects of BITs and FTAs only, not *all* provisions of those agreements. ISDS cannot be used to enforce, for example, tariff- or intellectual property-related aspects of FTAs.

## What is the purpose of ISDS?

ISDS is all about protecting investors’ investment overseas. Given the growth in foreign direct investment (FDI) seen over the past decade in particular, it is not surprising that investors want to know that their investments can be protected from inappropriate government action which constitute, in effect, damaging expropriation of their property.

ISDS essentially aims to prevent foreign governments from unjustly taking (either directly or indirectly) an investor’s assets; and compensating investors when this does happen and damage is caused.

It’s about holding governments accountable to the agreements they make. In short:

*ISDS aims to guarantee a safe, predictable framework for international investors as well as a depoliticised form of dispute settlement, so as to facilitate decisions and investments.<sup>1</sup>*

## Who decides whether a government is liable?

Arbitration proceedings take place in front of tribunals of (usually three) international experts. Each party (the investor and the state) chooses one expert, and may mutually agree on a third.<sup>2</sup> The rules of the arbitration are usually set by reference to neutral international bodies such as the United Nations Commission on International Trade Law (UNCITRAL) and the International Centre for Settlement of Investment Disputes (ICSID), in addition to the rules agreed to in the BIT or FTA.

The arbitration tribunal will use these rules to guide their analysis of the relevant law and facts, and determine whether the investor’s claim stacks up. If it does, then it will decide the amount of financial compensation that should be awarded.

These tribunals’ findings are binding and there is usually only limited opportunity to appeal.

**Figure 1 Successful claimants’ compensation**  
Compared to what they ask for

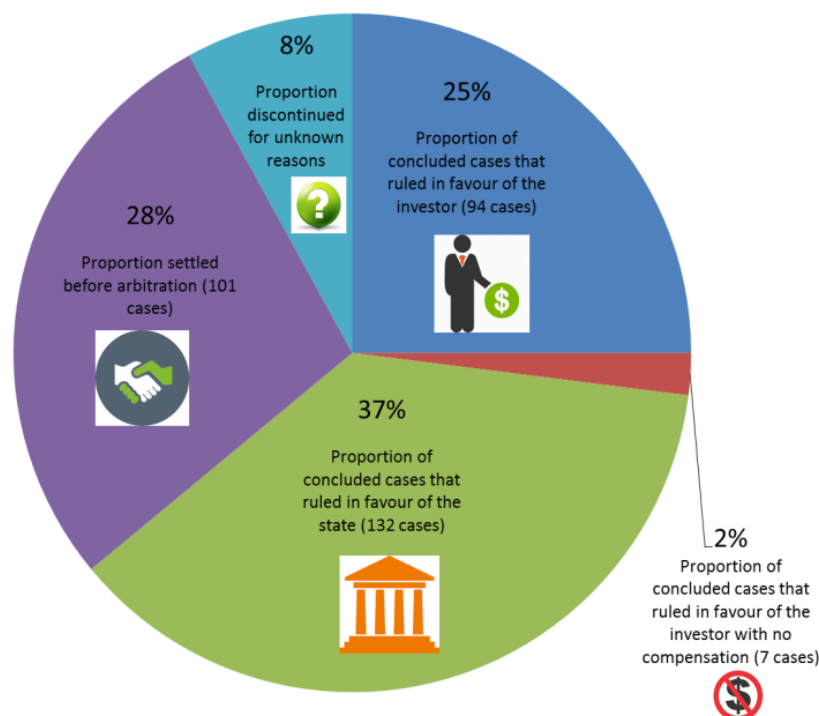


Source: Franck, 2007

<sup>1</sup> Fabry, E, and G. Garbasso. (2015). “ISDS in the TTIP: The devil is in the detail”. Jacques Delors Institute Policy Paper 122, January 2015.

<sup>2</sup> Or have the third appointed by an international organisation.

**Figure 2 How claims are settled**



Source: UNCTAD, in EC, 2015

**Table 1 ISDS by the numbers**

Number of BITs and FTAs globally	~3,200
Total no. of ISDS claims made (to end 2014)	608
ISDS cases concluded <sup>3</sup>	356
Claims made against New Zealand	0
Proportion of concluded cases that ruled in favour of the investor with compensation	25% (94 cases)
Proportion of concluded cases that ruled in favour of the investor with <i>no</i> compensation	2% (7 cases)
Proportion of concluded cases that ruled in favour of the state	37% (132 cases)
Proportion settled before arbitration	28% (101 cases)
Proportion discontinued for unknown reasons	8% (29 cases)
Compensation awarded per dollar claimed by investors	\$0.03
Share of claims by US investors from SMEs	67%
Number of claims made by US investors in past two years	11
Number of claims made by EU investors in past two years	60
Share of US investor claims settled in their favour	30%

Source: EC (2015)<sup>4</sup>; Franck (2007)<sup>5</sup>; CSIS (2015)<sup>6</sup>; TABC (2014)<sup>7</sup>

<sup>3</sup> 242 of these claims were made against just ten countries: Argentina, Venezuela, Czech Republic, Egypt, Canada, Ecuador, Mexico, India, the Ukraine and Poland.

## Are arbitration hearings carried out behind closed doors?

Increasingly not.

Many hearings are now highly transparent. Some are open to the public and are available to be viewed online. New Zealand's FTA with Korea requires ISDS proceedings to be open to the public, for example.

Importantly, the UN Commission on International Trade Law (UNCITRAL) has developed a set of rules on transparency which *expressly require* hearings to be accessible to the public, either physically or via the internet.

As these rules become standard practice, transparency will increase further, and as with any international system of dispute resolution, practices are always developing and improving. Best practice ISDS clauses now promote transparency and ensure interested parties may participate by way of amicus briefs.<sup>8</sup>

## Is ISDS a new and untested issue for New Zealand?

Hardly.

New Zealand's BITs with China (implemented in 1989) and Hong Kong (1995) include ISDS, as do a number of its FTAs. Once the recent Korea FTA enters into force, New Zealand will have ISDS provisions with 13 economies.

The bulk of these ISDS agreements have occurred more recently, however, including in our FTAs with China (2008), ASEAN and Australia (2009) and South Korea (2015).<sup>9</sup> As noted above, although the mechanism has existed for some time, no claims have been filed against New Zealand.

<sup>4</sup> EC. (2015). 'Investor-to-State Dispute Settlement: Some facts and figures'.

<sup>5</sup> Franck, S. D. (2007). 'Empirically Evaluating Claims about Investment Treaty Arbitration'. *North Carolina Law Review* 86 (2007): 57-59.

<sup>6</sup> CSIS. (2015). 'Investor-State Dispute Settlement: A reality check'.

<sup>7</sup> TABC. (2014). 'ISDS Fact Sheet'.

<sup>8</sup> Kalderimis, D. (2015). 'Investor/state arbitration, the TPP and New Zealand'. Presentation to Law and Economics Association of New Zealand seminar, 28 July 2015.

<sup>9</sup> Kalderimis (2015).

## Why are we contemplating signing up to ISDS in TPP?

ISDS is now commonplace in FTAs because these agreements increasingly seek to liberalise investment flows between countries, rather than just trade flows. ISDS can reduce the uncertainty associated with regulation, and uncertainty is the bane of investors' – including New Zealand firms' – lives.

In TPP, a number of the world's largest sources of investment are at the negotiating table. It's unrealistic to think that it could be taken off the table by a small country like New Zealand (even if we wanted to). But the ISDS outcome will be the result of negotiations between the 12 countries, all of whom want to preserve some policy space to regulate appropriately, and New Zealand will have a chance to help shape it.

That's the realpolitik argument for ISDS. But from an economic perspective, ISDS makes sense for New Zealand for two reasons.

- **New Zealand wants to encourage foreign investment.**<sup>10</sup> This is largely because of our thin domestic capital market and our inability to generate all the technology we need to stay competitive within our borders.

The government estimates that New Zealand needs \$160-200 billion of foreign investment to deliver its export and regional development targets – both of which encourage job and income growth and resilient regional economies.

As such we might see it as no bad thing to give assurances consistent with international law to investors confirming that their investments will be treated with respect and not subject to random or inconsistent government decisions. ISDS provides that assurance.

- **New Zealand firms want to invest overseas with confidence.** Exporting or investing from New Zealand is hard enough already.<sup>11</sup> It just gets harder with additional uncertainty that a foreign government might decide one day to expropriate assets, just because they feel like it.

As more Kiwi firms look offshore to diversify risks and get closer to international production networks and consumers, investing in countries with whom New Zealand has an ISDS arrangement provides a degree of comfort that the investment will be allowed to succeed without undue government interference.

## Does this mean foreign companies can change New Zealand laws?

No.

ISDS is primarily about financial compensation for breaches of investor rights that cause damages. Arbitration panels, although they have some power to grant interim relief, have no legal standing to require governments to change laws that foreign investors don't like.

However, it *is* true to the extent that ISDS clauses might indirectly influence governments when considering law changes that might affect foreign investors. Governments will need to consider the equitable treatment of investors from countries with whom they have ISDS arrangements – essentially ISDS points out the potential financial consequences of introducing laws that are clearly discriminatory and unfair.

In our view, that is no bad thing.

## Has the New Zealand government ever been sued before by foreign companies?

No.

Despite having had ISDS with 13 countries over the past 27 years,<sup>12</sup> the New Zealand government has never been sued by a foreign investor under an international treaty. That is likely to be due in large part to its open trade and investment regime, respect for the rule of law and clear and transparent legislative processes.

It may also reflect the fact that launching ISDS claims isn't cheap (firms can expect multi-million dollar costs), the probability of a win is low (see Figure 2) and the expected return per winning claim is just three cents on the dollar.

## Will ISDS impede New Zealand's sovereignty?

A common critique of ISDS is that it will restrict New Zealand's sovereign ability to make laws in the interests of the health and safety of its people or the environment. This is true to a limited degree, but the concern is often

<sup>10</sup> Of course, there will always be those who oppose foreign investment, but most analysts, businesses and politicians understand that closing New Zealand to foreign investment is not a sensible move in an increasingly globalised world, see NZIER. (2010). 'In defence of foreign investment'. NZIER Insight 17. [http://nzier.org.nz/static/media/filer\\_public/7d/f0/7df0f7b7-35ed-4226-bfd9-fcbf64f0f2bb/nzier\\_insight\\_17\\_-\\_in\\_defense\\_of\\_foreign\\_investment.pdf](http://nzier.org.nz/static/media/filer_public/7d/f0/7df0f7b7-35ed-4226-bfd9-fcbf64f0f2bb/nzier_insight_17_-_in_defense_of_foreign_investment.pdf).

<sup>11</sup> See, for example, Skilling, D., and D. Boven. (2006). 'The Flight of the Kiwi: Going Global from the End of the World', The New Zealand Institute Discussion Paper, 2006/1.

<sup>12</sup> Admittedly, although New Zealand has a BIT and an FTA investment chapter with prolific investor China, New Zealand does not currently have ISDS with any of the top 12 claimant home States (US, Netherlands, UK, Germany, France, Canada, Italy, Spain, Switzerland, Turkey, Belgium, Austria).

overblown, and often based on old ISDS arrangements that are no longer best practice.

Any time that New Zealand signs up to an international treaty or set of obligations – be it a global climate change agreement, international labour or human rights obligations, the UN Convention on the Law of the Sea or a trade/investment agreement – it cedes a certain amount of sovereignty.

But that's the whole point of such treaties: New Zealand agrees not to do some things in exchange for other countries not doing them too.<sup>13</sup>

Notions of sovereignty also need to be considered in the modern reality of global interconnectedness. As trade, investment, people flows and technology increasingly move through multi-country international production networks, it is unrealistic to think that any country can in all spheres just do what it likes without considering the potential impacts on other countries.

So the aim is not to restrict domestic sovereignty for the sake of it; it is to restrict the ability of governments to impose arbitrary, discriminatory policies that they agreed not to.

*[The] problem is not restricting domestic action, but doing so without sufficient forethought, balance, and political and institutional legitimacy<sup>14</sup>*

In short, ISDS retains governments' ability to regulate as they please, but with the clear understanding that actions that expropriate investors' private property in a discriminatory or unjustified way have consequences.

Again, this sounds like sensible public policy to us.

## How can we protect our right to legislate in the public interest of Kiwis?

Investment obligations, to which the ISDS process applies, are usually subject to a series of exceptions and safeguards that explicitly allow countries to "retain the right to impose non-discriminatory measures to protect public health, the environment, and worker and

consumer safety, and ISDS panels cannot overturn those regulations".<sup>15</sup>

*The risk of "regulatory chill" – which may cause governments to forgo the adoption of legitimate regulatory changes for the environment, health, or natural resources because of the threat of arbitration – can be avoided if the [agreement] includes adequate definitions of investment protection standards, appropriate exception clauses, and fair procedural safeguards<sup>16</sup>*

Some of the concern around ISDS relates to the definition of 'indirect expropriation' – where government actions have an effect equivalent to seizing investments or formally transferring titles without actually doing so. This means that defining what is and is not an indirect expropriation is important.

Investment obligations are usually clear that legislating in the public interest in a legitimate way does not amount to indirect appropriation. In the New Zealand-China FTA, for example, Annex 13 states that:

- 3. In order to constitute indirect expropriation, the state's deprivation of the investor's property must be:  
(a) either severe or for an indefinite period; and  
(b) disproportionate to the public purpose.*
- 4. A deprivation of property shall be particularly likely to constitute indirect expropriation where it is either:  
(a) discriminatory in its effect, either as against the particular investor or against a class of which the investor forms part; or  
(b) in breach of the state's prior binding written commitment to the investor, whether by contract, licence, or other legal document.*
- 5. Except in rare circumstances to which paragraph 4 applies, such measures taken in the exercise of a state's regulatory powers as may be reasonably justified in the protection of the public welfare, including public health, safety and the environment, shall not constitute an indirect expropriation.*

<sup>13</sup> Interestingly, a group of ten environmental NGOs, including Oxfam and WWF, have applied to the US Trade Representative to take the Peruvian government to dispute resolution under the US-Peru FTA – albeit not under an ISDS clause – because it has rolled back its environmental laws in order to promote foreign investment. See World Trade Online. (2015). 'USTR evaluating potential case against Peru environmental law changes'. <http://insidetrade.com/daily-news/ustr-evaluating-potential-case-against-peru-environmental-law-changes>. This is an example of how FTAs can be used to promote, rather than restrict, high quality environmental regulations.

<sup>14</sup> Kalderimis (2015).

<sup>15</sup> US Chamber of Commerce. (2015). '13 Myths about Investment Agreements and Investor-State Dispute Settlement (ISDS)'. <http://www.amcham.co.nz/Resources/Documents/13%20Myths%20about%20Investment%20Agreements%20and%20ISDS.pdf>

<sup>16</sup> Tietje, C., and F. Baetens. (2014). 'The Impact of Investor-State-Dispute Settlement (ISDS) in the Transatlantic Trade and Investment Partnership'. <http://www.rijksoverheid.nl/bestanden/documenten-en-publicaties/rapporten/2014/06/24/the-impact-of-investor-state-dispute-settlement-isds-in-the-ttip/the-impact-of-investor-state-dispute-settlement-isds-in-the-ttip.pdf>

# ISDS and sovereignty

Such an approach, if adopted in TPP, should ensure that the New Zealand government retains ample space to regulate appropriately in the interests of Kiwis.

## Does ISDS confer special rights on foreign companies?

It does to a certain degree.

ISDS gives foreign investors an additional adjudicatory option not available to New Zealand investors – that is, foreign investors can directly sue the New Zealand government without recourse to domestic courts. So ISDS *does* confer additional rights to foreign investors over domestic investors.

The question then becomes: how might this imbalance of rights be addressed?

One way is to avoid ISDS entirely (and take the risk that some foreign investors may be disincentivised from investing in New Zealand). And of course, refusing to sign up to ISDS could result in New Zealand having to withdraw from FTA negotiations. Given New Zealand's reliance on trade and foreign capital, this doesn't seem like a good idea – there is a “significant counterfactual risk” which needs to be considered.<sup>17</sup>

An option which would have fewer negative economic impacts is improving substantive property rights protection for Kiwi investors to bring it into line with customary international law. This would level the playing field with foreign investors and might involve introducing legislation that would guarantee compensation for the public expropriation of private property.

## What about the plain packaging case in Australia?

The most famous ISDS claim in this part of the world is the claim by Philip Morris Asia (PMA), a tobacco company, against the Australian government following the introduction of plain packaging on cigarettes in late 2012.<sup>18</sup> PMA argues that plain packaging constitutes an expropriation of its Australian investments (essentially its intellectual property associated with its packaging colours and branding) in an unfair and discriminatory fashion.

The very presence of the claim will have influenced New Zealand's negotiators at the TPP table – they will be all too aware of the risks associated with signing up to an ISDS clause that has loopholes that allow firms such as PMA to lodge similar claims.

The case is ongoing and will continue for much of 2015 and 2016. It is important to note at this stage that no decisions have been made by the appointed tribunal, so it is premature to pre-judge the outcome. Just because a claim is filed does not mean that it has merit. Modern investment treaties, including New Zealand's own BIT with Hong Kong, its FTAs, and the ICSID Arbitration Rules, now provide for a summary dismissal mechanism for frivolous claims and for costs to be awarded against investors. This procedure is not available in the (elderly) Hong Kong-Australia BIT governing the PMA claim.

## What's the alternative to ISDS?

There are limited other options available to protect foreign investments. Diplomatic channels and military action are the two most commonly used approaches historically. Relying on moral suasion via diplomacy or aggressive actions through the military are surely poor alternatives to sensibly-designed ISDS processes.

*Prior to the emergence of the ISDS system in the mid-twentieth century, investor state disputes that could not be resolved by direct investor-state dialogue or proceedings in domestic courts were either not settled or were handled by home State espousal of the claim via diplomatic processes or, at times, by the threat or use of military force.*

*Seen from this perspective, ISDS can be viewed as a progressive institutional innovation inasmuch as it helped to reduce sources of international tension and recourse to military force.<sup>19</sup>*

<sup>17</sup> Kalderimis (2015).

<sup>18</sup> Note that this claim was taken not under an FTA chapter, but under a 1993 BIT between Hong Kong and Australia. Philip Morris has also part-funded countries including the Ukraine, the Honduras and the Dominican Republic in bringing a claim before the World Trade Organisation, alleging that plain packaging laws are inconsistent with various aspects of WTO legislation. The outcome of this claim will be important for the New Zealand government – and many others – as they consider their options in the public health space in the future.

<sup>19</sup> OECD. (2012). 'Investor-State Dispute Settlement Public Consultation: 16 May - 9 July 2012'. <http://www.oecd.org/investment/internationalinvestmentagreements/50291642.pdf>

# ISDS and sovereignty

## So where does this leave us?

ISDS is a controversial topic. Strong proponents maintain there's absolutely nothing to worry about. Strident opponents raise spectres of evil multinational companies wanting to take New Zealand taxpayers for all that they can.

It's also complicated. Our view is that – as with any piece of international law – ISDS clauses are only as good or bad as the quality and skill with which they are drafted, and the analysis that sits beneath the positions taken.

New Zealand's negotiators are well aware of the risks associated with poorly-drafted ISDS clauses that contain loopholes that could be exploited. They will have learnt from the mistakes of other negotiators in previous BITs or FTAs. They have no interest in exposing New Zealand to unacceptable levels of risk.

Clearly, New Zealand negotiators have a challenge ahead of them to negotiate an ISDS clause that strikes a balance between providing assurances to foreign investors and preserving necessary domestic policy space – and all in the context of the end-game of the TPP negotiations that requires making numerous careful trade-offs between various aspects of the text and various countries.

But until we see the white of the negotiated outcome's eyes, there is little to be gained from scaremongering at the expense of informed debate.