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Changes in the Investor-State Litigation Process
As a Result of the Chile and Singapore Trade Agreements

This memorandum outlines the changes in the investor-state litigation process, relative to Chapter 11 of the North American Free Trade Agreement (NAFTA), made by the more recent Chile and Singapore trade agreements. These agreements have been signed by the President and as of July 2003 are awaiting congressional approval. This memorandum proceeds by outlining the primary concerns about the Chapter 11 process voiced by state and local government officials and others; describes the primary features of the Trade Promotion Authority Act of 2002; and discusses the investor-state litigation process in the Chile and Singapore trade agreements, with a primary emphasis on the novel aspects of these agreements. The basic conclusion of this memorandum is that while the Chile and Singapore agreements make some changes to the investor-state litigation process, they have not made any fundamental reform to the model established by NAFTA Chapter 11.

I. Primary Concerns About Chapter 11 of NAFTA.

In no particular order, a range of different groups and interests, spanning the ideological spectrum, have criticized the investor-state litigation process in NAFTA on a number of different grounds:

1. Greater Rights for Foreign Investors. Chapter 11 has been criticized as granting greater legal rights to foreign investors operating in the United States than U.S. investors possess.[1] The concern has been in part procedural, that is, that foreign investors (who can sue in U.S. courts like any other investor) have access to a special, quasi-judicial process not open to U.S. investors. The concern also has been substantive, that is, that the terms of the investor protection provisions in Chapter 11, and the emerging pattern of arbitral panel interpretations of these provisions, mean that foreign investors have a better chance of successfully suing the United States than U.S. investors would have under U.S. law. This concern about the substance of the law of Chapter 11 is grounded, in part, in the language of Chapter 11 and the rules of

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[1] Advocates of the investor-state mechanism have emphasized that investment provisions similar to those in NAFTA, which went into effect in 1994, were included in earlier bilateral investment treaties (BIT's). However, as pointed out in the Senate report on the Trade Promotion Authority Act of 2002, "there are no reported cases of foreign investor challenges to U.S. measures under the BIT's." Senate Report No. 107-139, 107th Congress, 2nd Session 12 (February 28, 2002). Understandably, therefore, concerns about the U.S. domestic implications of investment provisions did not come to the fore until after the adoption of NAFTA.

international law which are supposed to govern the interpretation of Chapter 11, as well as the arguably pro-investor slant of the Chapter 11 process as whole.

2. Undermining of U.S. Sovereignty. Related to the foregoing, critics have contended that the Chapter 11 process effectively undermines U.S. sovereignty by shifting the pre-existing legal balance of power between investors (at least foreign investors) and U.S. governmental institutions. While Chapter 11 only authorizes claims for monetary relief, it has been contended that significant monetary awards would inevitably produce prospective changes in the policies which produce such awards. The NAFTA implementing legislation apparently authorizes the United States to sue to preempt any state law or regulation which has been determined to violate Chapter 11. In the long run, critics contend, Chapter 11 will undermine the authority of government, at all levels, to protect the environment, public health, and other aspects of public welfare.

3. Erosion of Judicial Independence. The Chapter 11 litigation process has been viewed as undermining the traditional independence of the U.S. courts. This is so, first, because Chapter 11 arbitration panels, which have none of the salary and tenure protections of U.S. judges, will be deciding legal disputes which would otherwise be heard in U.S. courts. Second, and more importantly, arbitration panels have consistently ruled that they have the authority to directly review the rulings of U.S. courts to determine whether they violate Chapter 11.

4. Secrecy of Proceedings. Critics have argued that Chapter 11 arbitration panels violate cardinal principles of open government by refusing to allow public access to the records of Chapter 11 proceedings and by refusing to allow the public to attend hearings.

5. Lack of Third Party Rights. Critics also have raised the point that Chapter 11 proceedings differ from U.S. court proceedings in that Chapter 11 provides no mechanism for interested third parties to intervene in the proceedings, either as of right or by permission. In addition, there is no mechanism for the submission of amicus briefs.

6. Lack of an Appellate Mechanism. Chapter 11 includes no process for appellate review of individual arbitration decisions. As a result, critics have contended, there is no mechanism for correcting "mistaken" Chapter 11 rulings. Second, the lack of an appellate mechanism has been said to undermine the rule of law by impeding the development of a coherent set of definitive interpretations of Chapter 11.

7. No Mechanism for Dismissal of Groundless Claims. Various parties, including government officials responsible for implementing Chapter 11, have complained that Chapter 11 proceedings have become too time-consuming and complicated, even when the claims are relatively weak, because Chapter 11 includes no mechanism (such a 12(b)(6) motion under the federal rules) for dismissal of cases when the arbitration panel clearly lacks jurisdiction over the claim or the allegations plainly do not support a finding that Chapter 11 had been violated.

8. Granting Special Status to Investor Interests. More broadly, NAFTA has been criticized on the ground that it creates a special dispute resolution process that is highly favorable to business interests and which leaves other interests in society essentially unprotected at the international level. NAFTA does not create any international rules or procedures for the protection of the environment or workers, for example, but instead simply articulates a broad mandate that each country should abide by domestic environmental and labor laws.

II. The Trade Promotion Authority Act of 2002.

The Trade Promotion Authority Act, enacted in 2002, granted the President renewed "fast track" authority to negotiate international trade and investment agreements.. The key provision addressing the investor-state litigation process, section 2102(a)(3) of the Act, reads as follows. Specific language which reflects Congress' efforts to address the critics of the NAFTA Chapter 11 process is underscored.

> (3) FOREIGN INVESTMENT- Recognizing that United States law on the whole provides a high level of protection for investment, consistent with or greater than the level required by international law, the principal negotiating objectives of the United States regarding foreign investment are to reduce or eliminate artificial or trade-distorting barriers to foreign investment, <u>while ensuring that foreign investors in the United States are not accorded greater substantive rights with respect to investment protections than United States investors in the United States,</u> and to secure for investors important rights comparable to those that would be available under United States legal principles and practice, by–
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> (A) reducing or eliminating exceptions to the principle of national treatment;
> (B) freeing the transfer of funds relating to investments;
> (C) reducing or eliminating performance requirements, forced technology transfers, and other unreasonable barriers to the establishment and operation of investments;
> (D) seeking to establish standards for expropriation and compensation for expropriation, <u>consistent with United States legal principles and practice</u>;
> (E) seeking to establish standards for fair and equitable treatment <u>consistent with United States legal principles and practice, including the principle of due process</u>;
> (F) providing meaningful procedures for resolving investment disputes;
> (G) <u>seeking to improve mechanisms used to resolve disputes between an investor and a government through–</u>
> <u>(i) mechanisms to eliminate frivolous claims and to deter the filing of frivolous claims;</u>
> <u>(ii) procedures to ensure the efficient selection of arbitrators and the expeditious disposition of claims;</u>
> <u>(iii) procedures to enhance opportunities for public input into the formulation of government positions; and</u>
> <u>(iv) providing for an appellate body or similar mechanism to provide coherence to the interpretations of investment provisions in trade agreements; and</u>
> (H) <u>ensuring the fullest measure of transparency in the dispute settlement mechanism,</u>

to the extent consistent with the need to protect information that is classified or business confidential, by–

(i) ensuring that all requests for dispute settlement are promptly made public;

(ii) ensuring that–

(I) all proceedings, submissions, findings, and decisions are promptly made public; and

(II) all hearings are open to the public; and

(iii) establishing a mechanism for acceptance of amicus curiae submissions from businesses, unions, and non-governmental organizations.

The provision on investment in the final version of the trade law closely tracked the investment language from the Senate bill, passed on May 23, 2002. The Senate bill included a provision, which was not included in the House bill, stating that the principal negotiating objectives of the United States include "ensuring that foreign investors in the United States are not accorded greater rights than United States investors in the United States." This language was carried forward into the final bill, with one modification. The final version states that the principal negotiating objectives of the United States should include "ensuring that foreign investors in the United States are not accorded greater substantive rights than United States investors in the United States."

> The Conference committee report discusses the significance of this change in detail: The House recedes to the Senate with a technical modification to clarify that foreign investors in the United States are not accorded greater substantive rights with respect to investment protections than United States investors in the United States. That is, the reciprocal obligations regarding investment protections that the United States undertakes in pursuing its goals should not result in foreign investors being entitled to compensation for government actions where a similarly situated U.S. investor would not be entitled to any form of relief, while ensuring that U.S. investors abroad can challenge host government measures which violate the terms of the investment agreement. Thus, this language expresses Congress' direction that the substantive investment protections (e.g., expropriation, fair and equitable treatment, and full protection and security) should be consistent with United States legal principles and practice and not provide greater rights to foreign investors in the United States. This language applies to substantive protections only and is not applicable to procedural issues, such as access to investor-state dispute settlement. The Conferees recognize that the procedures for resolving disputes between a foreign investor and a government may differ from the procedures for resolving disputes between a domestic investor and a government and may be available at different times during the dispute. Thus, the ``no greater rights'' direction does not, for instance, apply to such issues as the dismissal of frivolous claims, the exhaustion of remedies, access to appellate procedures, or other similar issues.

House Report 107-624, 107th Congress, 2nd Session 156 (July 26, 2002).

The 2002 trade law marks a significant departure insofar as it establishes, as the benchmark for future trade and investment agreements, that foreign investors should not be accorded "greater substantive rights" than U.S. investors, that is, that investor-state litigation should "not result in foreign investors being entitled to compensation for government actions where a similarly situated U.S. investor would not be entitled to any form of relief." This language, though significant, obviously raises serious challenges in terms of implementation. In particular, how can it be determined, at least in the absence of direct U.S. court review of arbitral decisions, whether specific decisions do or do not depart from the substantive standards of U.S. law? As discussed below, the Chile and Singapore agreements, which are supposed to conform to the 2002 trade law, arguably fail to include any effective assurance that foreign investors will not receive greater substantive rights.

Moreover, the "no greater rights" new benchmark in the 2002 trade law is qualified. Insertion of the word "substantive" in the statutory text, as well as the conference report, make clear that greater procedural rights for foreign investors, such as the availability of the Chapter 11 process itself, does not violate the trade law. Also, the conference report indicates (though this is arguably in tension with the statutory text) that foreign investors should not be viewed as receiving greater substantive rights if they are granted the opportunity to obtain monetary relief in circumstances where that form of relief is not available against the government in U.S. courts.

Other specific issues raised by NAFTA critics and addressed by the trade law, at least to some degree, as reflected in the language quoted above, include (1) differences between the legal standards established by specific investor-protection provisions and the analogous provisions of U.S. law, (2) the secrecy of investor-state proceedings, (3) amicus filings, (4) the need for an appellate mechanism, (5) public access to investor-state proceedings, and (6) early dismissal of groundless claims.

III. The Chile and Singapore Agreements.

The Chile and Singapore trade agreements contain (essentially identical) provisions implementing the 2002 trade law and modifying the investor-state litigation process established by Chapter 11 of NAFTA. While the changes cannot be described as purely cosmetic, they are certainly modest. These latest trade agreements leave in place the basic mechanism of international arbitration panels, staffed by non-U.S. lawyers, reviewing U.S. government actions to determine whether they violate international law as well as the terms of the agreements themselves. The panels are empowered to make monetary awards which are, ostensibly, directly enforceable against the United States. U.S. court actions are subject to review by arbitration panels on the same basis as any other type of government action. In addition, there is no mechanism for review of arbitral awards by U.S. courts to determine whether they go beyond U.S. law.

The key elements of the investor-state litigation process under the Chile and Singapore agreements include the following. (Several instances where the two agreements differ are noted below.)

1. In terms of scope, the investor-state litigation process in both agreements is the same, and applies to all "measures," defined as "any law, regulation, procedure, requirement or practice." Relying on the same definition in NAFTA Chapter 11, arbitration panels have concluded that U.S. court actions are "measures" subject to challenge in international arbitration proceedings.

2. The agreements contain a new, more elaborate definition of investment. The definition includes domestic "licenses, authorizations, permits, and other similar rights," but defines these as protected investments only to the extent that they create "rights protected under domestic law." Thus, a revocable permit that does not represent a vested property right under U.S. law would not be an investment under these agreements.

3. Both the Chile and Singapore agreements expand upon the Chapter 11 model by providing for enforcement through the investor-state litigation process, not only of the investor-protection provisions in the agreements, but of certain other investment agreements to be negotiated in the future. These additional investment agreements are defined as "a written agreement that takes effect on or after the date of entry into force of this Agreement between a national authority of a Party and a covered investment or an investor of the other Party (i) that grants rights with respect to natural resources or other assets that a national authority controls, and (ii) that the covered investment or the investor relies on in establishing or acquiring the covered investment." This provision, though limited, expands both the scope and uncertainty associated with the international investor-state litigation process.

4. The provisions regarding "national treatment" (roughly speaking, the international law equivalent of the Equal Protection Clause) are essentially identical to the national treatment provision in NAFTA Chapter 11. This is not surprising because this provision has generated relatively less controversy than the other investor-protection provisions in Chapter 11.

5. The provisions regarding "minimum standard of treatment" are modified relative to the minimum standard of treatment provision in NAFTA Chapter 11. The changes essentially reflect the terms on an "interpretive" agreement made by the parties to NAFTA to clarify the scope of this investor protection provision.. Thus, the language in the new trade agreements makes clear that the minimum standard of treatment refers to the standard defined by "customary international law." In addition, the agreements state that inclusion of the terms "fair and equitable treatment" and "full protection and security" is not intended to create obligations which go beyond the standard established by customary international law. (In seeming contradiction of the statement that this language is not intended to add additional obligations, the agreements contain quite expansive definitions of each term. Thus, the agreements state that the obligation to provide "fair and equitable treatment" includes "the obligation not to deny justice in criminal, civil or administrative adjudicatory proceedings in accordance with the principle of due process embodied in the principal legal systems of the world." This capacious definition appears, for example, to reinforce the notion that U.S. judicial actions are subject to challenge in investor-state proceedings.) Finally, the agreements state, again in accord with the earlier NAFTA

interpretive agreement, that a determination that there has been a breach of another provision of the agreements, or of some other international agreement, does not establish a breach of the minimum standard of treatment.

As discussed above, the 2002 trade law indicated that U.S. trade negotiators should seek to "establish standards for fair and equitable treatment consistent with United States legal principles and practice, including the principle of due process." However, there is no reference in the new agreements to U.S. due process standards. While the agreements refer to international standards of due process, these standards are neither the same as, nor as well defined as, U.S. due process standards.[2]

6. The provisions regarding "expropriation" also differ slightly from the expropriation provision in NAFTA Chapter 11. First, whereas Chapter 11 referred to measures which directly or indirectly expropriate an investment, as well as measures which are "tantamount" to an expropriation., the investment provisions of the Chile and Singapore agreements omit the "tantamount" terminology. The United States had consistently maintained that the word "tantamount" added nothing to the "direct or indirect" language. Furthermore, so far as we know, no NAFTA panel has assigned determinative significance to the word "tantamount." Thus, the omission of this word appear to be largely if not entirely cosmetic.

Second, using essentially identical language, both agreements include letter exchanges and an annex ostensibly designed to clarify the meaning of the expropriation standard. This clarification draws, loosely speaking, from the factors in takings analysis under U.S. law as defined by the U.S. Supreme Court decision in Penn Central Transportation Co. v. City of New York. Using the Singapore letters of exchange to illustrate the approach taken in these agreements, the letters assert, first, that the investor protection standard on expropriation "is intended to reflect customary international law concerning the obligations of States with respect to expropriation." The apparent effect of this provision is to make clear that, whatever nod the agreement may make to U.S. domestic takings standards, the governing test is ultimately an independent, international law standard. Second, in recognition of the fact that the U.S. Takings Clause is limited to takings of "property" interests, the letters state that an action "cannot constitute an expropriation unless it interferes with a tangible or intangible property right or property interest in an investment." This is a potentially significant limitation on the scope of the expropriation standard, although the term "property" is not defined in the agreements and it is uncertain whether the term is supposed to be defined based on domestic or international law. Third, the letters distinguish between direct expropriation, "where an investment is nationalized

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[2] The Chile agreement contains the additional statement that customary interntional law "results from a general and consistent practice of States that they follow from a sense of legal obligation.... [T]he customary international law minimum standard of treatment of aliens refers to all customary international law principles that protect the economic rights and interests of aliens." This language appears to simply underscore that the minimum standard of treatment represents an interntional legal standard, not a standard defined by U.S. law.

or otherwise directly expropriated through formal transfer of title or outright seizure," and indirect expropriation, defined as an action which "has an effect equivalent to direct expropriation without formal transfer of title or outright seizure." Finally, the letters state that determining whether an action constitutes an indirect expropriation

> "requires a case-by-case, fact-based inquiry that considers, among other factors:
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> > (i) the economic impact of the government action, although the fact that an action or series of actions by a Party has an adverse effect on the economic value of an investment, standing alone, does not establish that an indirect expropriation has occurred;
> > (ii) the extent to which the government action interferes with distinct, reasonable investment-backed expectations; and
> > (iii) the character of the government action.

Summarizing the intended effect of this language, the letters state that "[e]xcept in rare circumstances, nondiscriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives such as public health, safety, and the environment, do not constitute indirect expropriations."

These clarifications of the expropriation standard will likely have some restraining influence on future arbitration panels interpreting this standard. On the other hand, the restraint may be more in the nature of atmospherics than substance. The <u>Penn Central</u> analysis, from which the three factors mentioned in the agreements are drawn, is famously unpredictable in its application. Furthermore, the language in the letters make a subtle but important change relative to the domestic <u>Penn Central</u> standard. With respect to the economic impact factor, the letters state that "adverse effect on the economic value of an investment, standing alone, does not establish that an indirect expropriation has occurred." The more familiar version of this statement in U.S. Supreme Court precedent (e.g. the <u>Concrete Pipe</u> decision) is that adverse economic impact standing alone, *no matter how serious*, is not sufficient to establish a taking. The U.S. Supreme Court's phraseology obviously contemplates a more restrained version of regulatory takings doctrine.

6. Both agreements "authorize" arbitration panels to accept and consider <u>amicus</u> filings. The agreements still make no mention of rights of intervention.

7. Both agreements contain detailed provisions authorizing arbitration panels to consider threshold defenses, such lack of jurisdiction, in an early and expeditious fashion.

8. With respect to an appellate mechanism, both agreements essentially "punt" on the issue, including placeholders looking toward the possible creation of some type of appellate mechanism in some future international agreement. Thus, the Singapore agreement states: "If a separate multilateral agreement enters into force as between the Parties that establishes an appellate body for purposes of reviewing awards rendered by tribunals constituted pursuant to interntional trade or investment arrangements to hear investment disputes, the Parties shall strive to reach an agreement that would have such appellate body review awards rendered [under this

agreement] in arbitrations commenced after the appellate body's establishment." Insofar as the creation of an international appeals court would bring to the fore the potential conflicts between such a court and the Supreme Courts of the States and of the United States, it may not be surprising that the drafters of these agreements deferred this issue.

9. The agreements also contain detailed provisions designed to ensure that arbitration provisions will be transparent and open to the public, subject to various provisions safeguarding information related to national security or information "the disclosure of which would... prejudice the legitimate commercial interests of particular enterprises, public or private."

10. Finally, in contrast to both NAFTA Chapter 11 and the Singapore agreement, the Chile agreement has a particularly strong election of remedies provision, under which an investor who sues in Chilean courts for breach of an investor-protection obligation, including specific future agreement regarding natural resources, may not later sue under the international arbitration process.

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In general, the Chile and Singapore trade agreements make relatively modest changes to the model established under NAFTA Chapter 11. The most extensive changes relate to the openness of the proceedings and, to a more limited extent, third party participation. Depending on one's perspective on the investor state-litigation process, these reforms can be viewed as either positive or negative. On the one hand, they help ensure that the investor-state proceedings will more fully conform to the standards of openness followed in U.S. courts. On the other hand, they can be viewed as helping to bolster the legitimacy of investor-state litigation without, arguably, addressing the more fundamental concerns about this process. In particular, the reforms in the Chile and Singapore agreements do essentially nothing to address the basic concern about quasi-judicial panels reviewing the legality of U.S. sovereign actions, including U.S. judicial actions, and applying legal standards which differ from, and likely go beyond, the protections granted investors by U.S. law. In sum, if one views the NAFTA Chapter 11 investor-state litigation process as problematic, there is nothing of substance in the Chile and Singapore agreements likely to persuade an objective observer that the problems have been solved.

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