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Wesley Scholz  
U.S. Department of State  
Office of Investment Affairs (EB/IFD/OIA)

James Mendenhall  
Office of the U.S. Trade Representative  
Office of Services, Investment, and IPR

By Fax and Electronic Mail

Dear Mr. Scholz and Mr. Mendenhall:

As the U.S. Department of State and the Office of the U.S. Trade Representative (USTR) move forward expeditiously to produce a new model bilateral investment treaty (BIT), we write to reiterate our numerous concerns regarding the impact of the draft model text on the capacity of U.S. and foreign government authorities to protect the public interest.

Because of these impacts, the development of a model BIT is a major policy initiative that your agencies should not undertake without meaningful and effective consultation with the public and Congress, and thorough assessment of the implications of the draft model BIT for sustainable development, the environment, health and safety, and workers' rights, in the United States and throughout the world.

Expansion of investment can and must be made compatible with the protection of the public interest in the United States and overseas. Regrettably, it is our understanding that the State Department and USTR are presently considering a model BIT that perpetuates many of the flaws of earlier treaties. The result is a missed opportunity to correct the shortcomings of the past and chart a new course for investment rules that emphasizes a balanced approach to ensuring both investor rights *and* responsibilities.

Specifically, the draft model BIT creates a set of rights for investors (including foreign investors in the U.S.), but fails to establish obligations for investors and corporations in the communities in which they operate. Further, by establishing "investor-state" dispute settlement procedures that will allow foreign investors to challenge U.S. and foreign public interest laws and regulations directly, the draft model BIT would provide a potent tool to foreign investors to assert the imbalanced rights provided by the treaty.

Moreover, claims made under these agreements will be decided by *ad hoc* panels that are not trained in or bound by U.S. Supreme Court precedent. In addition, the decisions of these panels are not subject to review by U.S. courts to ensure that they do not deviate from U.S. law and grant greater rights to foreign investors, or to any other appellate review to ensure quality and consistency.

In sum, we believe the result is a draft model BIT that poses many significant threats to public interest protections for sustainable development, the environment, health and safety, and workers' rights. We outline below some of our most serious concerns with the proposed model BIT. We address both procedural and substantive issues, including the failure of the draft model BIT to ensure that the rights provided by the investment rules are limited to those accorded under U.S. law to U.S. citizens. We urge your agencies to refrain from finalizing the model BIT while these concerns have not been fully addressed.

## **Procedural Issues**

### **I. Government Screen for Direct-Investor State Disputes**

The draft model BIT appropriately limits the ability of foreign investors to bring claims involving taxation measures and provides a government screen for such claims to ensure that the public interest is adequately protected. Similarly, the draft model BIT provides a government screen for claims involving financial services measures taken for prudential reasons. We believe that other public interest measures deserve the same level of protection that is provided to tax policy and financial services regulation.

The governments that are parties to the agreement should have the opportunity to prevent investment cases from proceeding if, for example, the claim is inappropriate, without merit, or would cause serious public harm. At a minimum, we urge that health and safety, environmental, consumer protection, and human and labor rights measures be treated in the same manner as taxation measures. Providing such a screen for direct investor-state disputes would in no way impede the ability of a government itself to bring a claim against the other government. Moreover, if both countries do not agree to bar a claim within a fixed period of time, then the direct investor-state claim would be allowed to proceed.

### **II. Exhaustion of Remedies**

By not requiring that claimants exhaust domestic remedies before bringing investment claims, the draft model BIT does not comport with U.S. or international law, and we urge that exhaustion of remedies be included in the model BIT. Under U.S. law, investors must exhaust all available procedures for obtaining compensation before bringing a regulatory takings claim under the Takings Clause of the Fifth Amendment. By not

requiring such exhaustion, the draft model BIT provides foreign investors greater rights than those enjoyed by U.S. citizens.

International law similarly requires that foreign investors exhaust domestic administrative and judicial remedies before pursuing claims before international tribunals. In human rights cases, for example, claimants are required to exhaust domestic remedies before bringing a claim to an international tribunal.

Further, the lack of an exhaustion requirement means that investors can altogether avoid pursuing claims in a domestic legal system. Taking such claims to international tribunals without first requiring domestic courts with expertise in these matters to review the claim, develop a factual record and provide interpretations of domestic law invites international tribunals to misread domestic laws and reach inconsistent and erroneous decisions. This is particularly inappropriate where the domestic legal system is well-developed, such as in the United States. In addition, removing the cases from domestic legal systems undercuts the likelihood that countries will achieve a sustainable rule of law. Requiring foreign investors to exhaust domestic remedies would help to build the capacity of judicial systems in developing countries to address disputes concerning foreign investment and would help build and sustain the rule of law in those countries. Rather than allowing investors to jump immediately to international tribunals, they should at least be required to test the domestic legal system in host countries.

### III. Denial of Benefits

Significantly, the draft model BIT's language on Denial of Benefits in Article 17(2) would explicitly permit U.S. corporations to use the investor-to-state dispute settlement process against the United States by using a foreign subsidiary in the other Party to the BIT, so long as the U.S. corporation has "substantial business activities" in the other Party. We are concerned that this provision could inappropriately be used by U.S. corporations to avoid the normal "diversity of nationality" requirement for investors to state arbitration before international tribunals.

### IV. Appellate Mechanism

We are deeply disappointed that the draft model BIT does not include a meaningful, effective, independent appellate mechanism. In the Trade Act of 2002, Congress directed USTR to seek the creation of "an appellate body or similar mechanism to provide coherence to the interpretations of investment provisions in trade agreements." Such coherence is just as important in BITs as in trade agreements, and the administration should follow the will of Congress by creating an appellate mechanism in new BITs. Merely providing that the parties to the agreement shall consider in the future whether to establish such a mechanism is insufficient.

## **Substantive Issues**

## I. Failure to Meet the “No Greater Rights” Standard

The draft model BIT does not accomplish the congressional mandate in the Trade Act of 2002 requiring that investment rules not grant foreign investors greater substantive rights than U.S. investors are afforded under U.S. law. While the Trade Act does not expressly apply to investment rules in BITS, we believe that the desire of Congress concerning investment provisions in trade agreements should be respected in the negotiation of BITS. Unfortunately, however, the draft model BIT fails to adequately reflect U.S. law, or even international law, in many respects, and fails to apply longstanding and fundamental principles of U.S. Supreme Court jurisprudence.

Given these concerns, it is essential to emphasize that we believe that USTR cannot ultimately comport with the “no greater rights” congressional mandate if foreign investors are able to bring claims that would be decided by ad hoc panels that are not trained in or bound by U.S. Supreme Court precedent and that would not be subject to review by U.S. courts to ensure that they do not in fact deviate from U.S. law and grant greater rights to foreign investors. The prospects of such panels engaging in subjective balancing tests, and on the basis of those, imposing financial liability on the U.S. for regulatory actions, is extremely troubling.

This fundamental failure to meet the “no greater rights” test occurs in at least several critical parts of the investment rules discussed below – Expropriation, Minimum Standard of Treatment, and the Definition of Investment.

### A. Expropriation

Concerning expropriation, it is of serious concern to us that, in attempting to define a standard, the draft model BIT uses a limited, and imbalanced, set of the critical factors used by the Supreme Court in determining takings cases. In setting out some of the indispensable factors that must bind decisions on whether an “indirect expropriation” has occurred, we believe each of the problems we identify must be addressed to ensure that the current draft model BIT does not breach the ceiling of U.S. law.

- The draft model BIT fails to state that a government regulatory action taken to address a public nuisance cannot be considered a taking, or expropriation. *Lucas v. South Carolina Coastal Council*, 505 U.S. 1003, 1029 (1992).
- The draft model BIT does not include the critical Supreme Court principle that a governmental regulatory action must be analyzed in terms of its permanent interference with a property in its entirety in order to determine whether a taking has occurred. This standard prevents segmenting a property, whether measured in terms of area or time, as clearly articulated in the Supreme Court’s *Tahoe-Sierra* case, which rejected a taking claim arising out of a temporary moratorium on development. *Tahoe-Sierra Preservation Council, Inc. v. Tahoe Regional Planning Agency*, 122 S. Ct. 1465 (2002)

- The draft model fails to include the Supreme Court’s fundamental distinction between land and “personal property.” “In the case of personal property, by reason of the State’s traditionally high degree of control over commercial dealings, [the owner] ought to be aware of the possibility that new regulations might even render his property economically worthless (at least if the property’s only economically productive use is sale or manufacture for sale).” *Lucas v. South Carolina Coastal Council*, 505 U.S. 1003, 1028 (1992).
- The draft model BIT fails to provide explanations and limitations for critical standards from Supreme Court jurisprudence, including the use of “character of government action” as a factor in expropriation analysis. “Character of government action” is extraordinarily ambiguous and could easily be misapplied by tribunals that are neither trained in nor bound by U.S. precedent.
- The draft BIT language concerning the analysis of an investor’s expectations is too vague, leaves too much to the discretion of the arbitrators, and does not indicate the deference to governmental regulatory authority that is found in U.S. jurisprudence. The proposal does not include critical limitations stating that an investor’s expectations are a necessary, but not sufficient, condition for liability, that an investor’s expectations must be evaluated as of the time of the investment or that an investor must expect that health, safety, and environmental regulations often change and become more strict over time.
- In considering whether a regulatory action constitutes an expropriation, the draft model’s language does not clearly include the standard established in Supreme Court jurisprudence that an adverse effect on economic value does not by itself constitute an expropriation, *no matter how serious the adverse effect*. In *Concrete Pipe*, a unanimous Supreme Court used the phrase “however serious” to clarify its “long established” standard: [O]ur cases have long established that mere diminution in the value of property, however serious, is insufficient to demonstrate a taking *Concrete Pipe & Products v. Construction Laborers Pension Trust*, 508 U.S. 602, 645 (1993).
- The language in paragraph 4(b) of Annex B of the draft model BIT clarifying that the exercise of regulatory powers by governments only constitutes an expropriation in “rare circumstances” needs to be strengthened to accurately reflect U.S. law. We believe that “rare circumstances” fails to adequately convey the degree to which it is unlikely that a regulatory action would be considered an expropriation under U.S. law. It would take an extreme circumstance for any of the thousands of our country’s laws and regulations to be found to constitute an expropriation. As the Supreme Court unanimously stated in the *Riverside Bayview* case, land-use regulations may constitute a taking in “extreme circumstances.” *United States v. Riverside Bayview Homes, Inc.*, 474 U.S. 121, 126 (1985).

B. Minimum Standard of Treatment

In regard to the minimum standard treatment, we are deeply concerned that the standard in the draft model BIT is a completely unbounded and open-ended one, with no clear definition. The standard therefore could be interpreted by tribunals in ways that go far beyond U.S. law.

For example, we are concerned that the term “fair and equitable treatment” has been included as an essential element of the standard. While we welcome the clarification that “fair and equitable” treatment “includes” procedural due process, this in no way eliminates the significant potential of a broader, open-ended interpretation of the standard. “Fair and equitable treatment” opens the door to outcomes in investment cases that are in no way limited by, or consistent with, U.S. law.

- There is no right corresponding to “fair and equitable treatment” under U.S. law. The closest thing in U.S. law is the Administrative Procedure Act (APA), which allows a court to review federal regulations to determine whether they are “arbitrary or capricious.” But the APA’s standard is presumably more difficult for claimants to prove than “fair and equitable” (which invite a balancing of all facts and circumstances), and the APA does not apply to many governmental actions (e.g., legislation, court decisions, actions by state, local and tribal governments, and exercises of prosecutorial discretion) that are covered under investment agreements. Moreover, the APA does not provide for monetary damages (as these investment provisions would allow); only injunctive relief is allowed. Finally, U.S. courts are bound by deference doctrines in applying the APA; there are no equivalent doctrines in treaties or other international law, to our knowledge, and certainly no doctrine of deference is articulated in the model BIT.
- In addition, the “fair and equitable” language, if viewed as an independent standard, is extremely dangerous to good governance. It would invite an investment tribunal to apply its own view of what is “fair” or “equitable” unbounded by any limits in U.S. law. Those terms have no definable meaning, and they are inherently subjective. Indeed, we wonder how they can have any principled meaning when applied to countries with such different histories, cultures, and value systems as are involved in BITs. The kind of second-guessing of governmental action—e.g., legislation, prosecutorial discretion, police action, court decisions, regulatory actions, zoning decisions, etc., at all levels of government—invited by this type of standard is antithetical to democracy.

### C. Definition of Investment

The definition of “Investment” in the draft model BIT is much broader than the real property rights and other specific interests in property that are protected under the Takings Clause, and includes “every asset that an investor owns or controls, directly or indirectly, that has the characteristics of an investment, including such characteristics as the commitment of capital or other resources, the expectation of gain or profit, or the assumption of risk.” Under the U.S. Constitution, in contrast, such broad economic interests are not considered forms of property that are protected by the Takings Clause.

However, the model BIT definition does not recognize the Supreme Court's holdings that property interests are limited by background principles of property and nuisance law. *Lucas v. South Carolina Coastal Council*, 505 U.S. 1003, 1029 (1992). Furthermore, the language in the draft model BIT has been extended from previous investment agreements to explicitly include "futures, options, and derivatives", and it exceeds customary international law for state responsibility for injuries to aliens.

## II. Agreements Relating to Natural Resources and Other Assets

The grant of arbitral jurisdiction for claims based on a breach of "an investment authorization" or "an investment agreement" involving natural resources and other government assets undermines domestic legal systems by removing an important class of disputes from them and by opening whole new areas of potential investor challenges to domestic regulatory programs. This expansion of the investor-state arbitration is especially problematic because these disputes can involve judging not only propriety of the collection of royalties over natural resource extraction, but also the validity of measures adopted by U.S. agencies to ensure compliance with regulations, such as permits.

The investment agreements covered by these jurisdictional grants are not commercial disputes, but involve important policy questions regarding public assets; including natural resources such as oil, gas, timber, water, etc. Moreover, the inclusion of "assets that a national authority controls" in the draft model BIT is broad enough to encompass, *inter alia*, disputes over government procurement, services, and a number of regulations and permits.

In particular, we are concerned that the new jurisdictional grants make any dispute and all issues arising out of these agreements actionable for damages before unaccountable, *ad hoc* arbitral tribunals outside the U.S. legal system. Whether a party is in breach of investment agreements or authorizations should be determined under applicable U.S. law, and through the statutorily mandated process of administrative courts followed by appeal, if necessary, to U.S. federal courts. That comprehensive body of law defines the competence, rights and obligations of the U.S. government regarding its contracts, including those concerning natural resources. Similarly, that procedural system ensures fairness and consistency in dealing with the multitude of issues involved in U.S. government contracting. It is also critically important that legitimate U.S. regulatory decisions (e.g., regarding health, environmental, communications, energy, and nuclear issues) be tested in the U.S. court system and be subject to U.S. laws, not subject to second-guessing by *ad hoc* arbitrators.

## III. Capital Controls

We are deeply concerned that the provisions on transfers in the draft model BIT would limit governments' ability to use legitimate measures designed to restrict the flow of capital in order to protect themselves from financial instability. During the currency

crisis that plagued East Asia in the late 1990s, for example, unimpeded flows of capital devastated national economies, throwing thousands of people out of work and into precarious and unsustainable livelihoods. Without adequate measures to prevent and respond to such financial instability, broad sustainable development will remain out of reach for many developing countries. The increased frequency and severity of financial crises also hurts U.S. economic interests, as crisis-stricken countries devalue their currencies and flood the U.S. market with under-priced exports in order to recover.

Full capital account liberalization has not been shown to be necessary to stimulate investment flows, deepen capital markets, or enhance economic growth. In a March 2003 report, the International Monetary Fund (IMF) noted the lack of a correlation between financial integration and economic growth. Further, the IMF has indicated support for the availability of capital controls as a policy tool and no longer insists on full capital account liberalization as a requirement for its borrowers.

The United States should ensure – for the sake of developing economies, international financial stability, and its own economic interests – that countries have the policy flexibility needed to impose capital controls in appropriate circumstances.

#### IV. Investment and Environment/Investment and Labor

The inclusion of “Article 12: Investment and Environment” and “Article 13: Investment and Labor” reflects the important recognition that investments may compromise environmental quality and workers’ rights and that a country may weaken environmental protection and labor standards in order to attract investments. These provisions suffer from structural flaws that render them hollow, however. First, the content of the obligations is extremely limited, as evidenced by the use of “each Party shall strive to ensure”, instead of a mandatory “shall ensure”. Second, each provision has a footnote that limits its scope solely to federal laws and regulations, leaving aside all other sub-national environmental laws. This limitation is particularly noteworthy given that the scope of the draft model BIT otherwise covers measures adopted or maintained by a Party, which includes all governmental organs and other entities exercising public functions. Third, the procedural mechanisms to ensure compliance with these provisions are also exceptionally weak, as further proceedings beyond consultations are excluded.

Finally, the second paragraph of draft Article 12 attempts to safeguard a Party’s ability to adopt, maintain, or enforce measures necessary for the protection of the environment. Given the broad range of government measures an investor could challenge under the draft model BIT, it is essential that this safeguard be binding and effective, and that it apply to environmental protection measures as well as other government measures vital to the public interest, such as laws protecting consumers, health and safety, and workers’ rights and human rights. Yet there is no provision analogous to Article 12(2) under the labor article or any other place in the draft model BIT. Unfortunately, even the limited safeguard for environmental protections in Article 12(2) is rendered meaningless by the qualification that only those environmental measures “otherwise consistent with this

Treaty” may be protected from challenge. Thus, the use of Article 12(2) as a defense or exception to the other substantive obligations of the BIT appears to have been severely constrained or even eliminated. Article 12(2) cannot operate as a defense or exception to the other substantive obligations of the BIT, which in effect means that a Party may be ordered to pay damages to an investor even for adopting a measure necessary to protect the environment.

#### V. Preambular Language

Although the preamble of a treaty does not constitute a source of obligation *per se*, it provides guidance in interpreting the meaning and scope of the agreement’s obligations. The NAFTA and the WTO demonstrate the importance of including references to important public policy goals such as environmental protection and sustainable development in situating the respective agreements in the broader international legal context. The draft model BIT, however, fails to state that the goal of the BIT is sustainable development, and its preambular references to the public interest objectives of health, safety, the environment and workers’ rights are extremely weak. In fact, the draft language may be even weaker than the preamble of the existing model U.S. BIT, which explicitly states that parties agree that their investment objectives can be met “without relaxing health, safety and environmental measures of general application.” While such a statement should be binding rather than preambular, the failure to even include it in the preamble further invites tribunals to interpret the BIT with a singular focus on the primacy of private capital flows, and with disregard for the broader public interest.

#### VI. Most Favored Nation

The implications of the most favored nation (MFN) treatment are widespread and affect important public interest issues. We are particularly concerned that the lack of clarity in the text concerning MFN leaves open the possibility that foreign investors covered by a BIT could use the MFN principle to assert rights provided by other investment agreements or treaties that a host government has entered into. This could result in investors using the MFN to claim greater rights than are provided under the BIT that was agreed to by their home country. This is particularly problematic given the attempt in the new model BIT to adjust some of the expropriation and minimum standard of treatment disciplines found in NAFTA Chapter 11 and to provide more transparency and public participation. Investors may be able to invoke MFN to circumvent these attempted limitations and gain the full set of rights accorded to foreign investors under NAFTA.

Conversely, foreign investors who enjoy the right to MFN through an existing trade agreement or other treaty could wield that MFN obligation to demand the full new set of rights – both substantive and procedural – granted to foreign investors in the model BIT. A German investor, for example, with a right to MFN under the 1956 Treaty of Friendship, Commerce, and Navigation between the U.S. and Germany, could claim the

additional rights accorded to other foreign investors under the new model BIT, including possibly the right to direct investor-to-state dispute resolution.

The unfettered application of the MFN clause in investment agreements would thus push towards a harmonized and enlarged system for the protection of investments, where investors could pick the most favorable standards and dispute settlement mechanisms. Further, such expansive interpretations of the MFN clause blur the distinctions between procedural and substantive elements in international agreements, thereby threatening to expand investor-state arbitration to treaties contemplating other mechanisms for the resolution of disputes, e.g. Treaties of Friendship, Commerce, and Navigation.

To respect the fundamental public policy considerations that the Parties envisaged when entering into international agreements, explicit limitations to the MFN clause should be established either in its construction or as exceptions to its disciplines.

## VII. National Treatment

The broad scope of the “national treatment” non-discrimination principle in the draft model BIT leaves the principle open to interpretations by international tribunals that could have negative consequences for appropriate environmental, health and safety, and other public interest protections. As has been the case in WTO jurisprudence, the principle can be interpreted by tribunals as prohibiting regulatory actions that result in “de facto” discrimination, even when there is no facial or intentional discrimination involved. For example, an otherwise neutral regulatory action to protect the environment that results in a disproportionate impact on a foreign investor could run afoul of this standard. We believe that national treatment should be explicitly limited to instances in which a regulatory measure is enacted for a primarily discriminatory purpose.

Given all of these concerns, we urge your agencies not to finalize the draft model BIT in its current form. International investment rules must create a balance between investor rights and responsibilities, and guarantee that governments have needed flexibility to protect important public policy goals such as environmental protection, health and safety, and workers’ rights. In addition, any investment treaty the U.S. enters into should ensure that foreign investors are granted no greater rights than U.S. citizens under domestic law. The current model BIT falls short of these goals. We urge you to withdraw the current draft until completing a thorough consultation with the public and Congress and fully addressing the concerns above.

We look forward to your response.

Sincerely,

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cc: Members of the Senate Foreign Relations Committee