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INVESTMENT PROVISIONS IN THE KOREA FTA: A RADICAL SHIFT OF POWER TO FOREIGN INVESTORS

SUMMARY

The investment provisions in the Korea-U.S. Free Trade Agreement (Korea FTA) constitute a major and potentially devastating change in U.S. investment policy. For example, new language radically changes the test for what constitutes an expropriation, making it considerably more likely that good faith environmental, health and safety regulations will be found to be expropriations requiring compensation. Other language makes that perverse result even more likely with respect to efforts to regulate emerging technologies, such as biotechnology or nanotechnology. Another example is that new language declares that all contract rights are property rights subject to investor-State arbitration. These and other provisions differ in important respects from language in preceding U.S. agreements—including the U.S. Model Bilateral Investment Treaty (BIT) and other recent free trade agreements (FTAs). The expropriation provisions in the Korean FTA have no precedent in U.S. law, and they unquestionably provide foreign investors greater protection than U.S. investors have in the United States.

I. THE INVESTMENT PROVISIONS OF THE KOREA FTA FAIL TO MEET THE "NO GREATER SUBSTANTIVE RIGHTS" REQUIREMENT OF THE TRADE ACT OF 2002

The Trade Act of 2002 requires that investment provisions "ensur[e] that foreign investors are not accorded greater substantive rights with respect to investment protections than United States investors in the United States. . ." Section 2102(b)(3).

The Korea FTA clearly reflects a departure from the investment provisions in previous agreements to which the United States is a party, including North American Free Trade Agreement (NAFTA) Chapter 11, as well as from the U.S. Model BIT; and these changes fail to meet the standard set by Congress.

The new language fails to adequately reflect U.S. law–or even international law, in many respects–including the particular Supreme Court decision, *Penn Central*, on which the U.S. government has based the standard for expropriation in past agreements.

EXPROPRIATION. The treatment of expropriation in FTAs is of major importance to the ability of the United Sates and other countries to enact and enforce environmental, health and safety standards. The concern is that arbitral panels will interpret the expropriation provision in ways that unduly restrict host countries' ability to protect the environment, public health and safety (both consumer safety and worker safety), thus eliminating domestic policy space necessary to protect our society and future generations. This concern is based both on the content of the expropriation law and on a concomitant concern that arbitral tribunals are not institutionally competent to judge the efficacy or appropriateness of environmental, health and safety measures adopted by the United States and its state and local governments. For example, investment arbitral tribunals tend to be composed of experts in international investment law with no expertise in laws regarding protection of the environment, health or safety; the operation of arbitral tribunals is not subject to the same transparency and public participation as are courts in the United States and most other countries; and arbitrators' judgments are for all relevant purposes not subject to appeal or review.

The Korea FTA includes several new elements protecting foreign investors that have no counterparts in U.S. law, or previous U.S. FTAs and the U.S. Model BIT. The language in the U.S. Model BIT was crafted to achieve a balance between protecting foreign investors and protecting the United States' (and other countries') ability to take regulatory actions, including those to protect the environment, public health, and safety. Any changes to the U.S. Model BIT thus must be given close scrutiny. Unfortunately, the new language does not pass muster.

New tests for expropriation. Most importantly, paragraph 3(b) of Annex B of the Investment Chapter of the Korea FTA creates two new dangerous tests for what constitutes an indirect expropriation: whether a regulatory action is "extremely severe;" or whether a regulatory action is "disproportionate in light of its purpose of effect." The new tests are objectionable on at least three grounds. First, they have no antecedent in U.S. or international investment law, so this annex is making new and untested law. Second, the tests, especially the second one, provide great discretion and latitude to arbitrators to strike down good faith laws enacted by Congress and signed by the President to protect the environment, health and safety, as well as regulations and enforcement actions taken pursuant to those laws: all that is required is that two of the three arbitrators on a panel decide that a measure is disproportionate in light of either its purpose or its effect. Third, the tests obviously provide foreign investors greater rights than U.S. investors have under our law, because, for example, the U.S. Supreme Court has never held that an expropriation or taking can be found simply because judges believe that a measure is disproportionate. The Korea-U.S. agreement thus violates the Trade Act of 2002's prohibition against providing foreign investors with greater rights than U.S. investors have in the United States.

Paragraph 3(a) of Annex B makes two other changes. The first change is the addition of footnote 18 to sub-paragraph (ii), which reads: "For greater certainty, whether an investor's investment-backed expectations are reasonable depends in part on the nature and extent of governmental regulation in the relevant sector. For example, an investor's expectations that regulations will not change are less likely to be reasonable in a heavily regulated sector than in a less heavily regulated sector."

The footnote's second sentence is based on the incorrect assumption that regulatory changes are more likely to occur in heavily regulated sectors than in heretofore lightly regulated sectors, and thus could lead to unwarranted findings of indirect expropriation. This generalization ignores elements such as the novelty of a sector, potential changes in scientific understanding of risks, and experience in regulating a sector. In the process, it both makes it more likely that good faith environmental, health and safety regulatory measures (e.g., regarding emerging technologies such as biotechnology or nanotechnology) will be found to be compensable expropriations, and that the Trade Act of 2002's prohibition against providing foreign investors with greater rights than U.S. investors have in the United States will be violated.

In addition, sub-paragraph (iii) introduces a new concept–"special sacrifice"–that is unknown to U.S. and international investment law. Sub-paragraph (iii) states: "the character of the government action, including its objectives and context. Relevant considerations could include whether the government action imposes a special sacrifice on the particular investor or investment that exceeds what the investor or investment should be expected to endure for the public interest." We understand that "special sacrifice" is a Korean legal concept, based on German law. In any event, its application in international investment arbitration is purely speculative. Also, the sentence could easily be read as a test that arbitrators can apply to determine whether an indirect expropriation had occurred. As discussed above, such tests–including this one–are unprecedented and increase the danger that good faith regulatory measures will be found to be compensable expropriations.

Missing First Paragraph. The U.S.-Korea FTA drops a paragraph from the U.S. Model BIT, which states that the expropriation article "is intended to reflect customary international law concerning the obligation of States with respect to expropriation." That paragraph, which is in the U.S. Model BIT and most other recent U.S. FTAs, is important because it sets the context for the entire expropriation analysis, placing it firmly within customary international law and thus providing boundaries to the analysis and to arbitrators' power to declare environmental, health and safety regulations to be expropriations requiring compensation. Because customary international law includes the so-called Police Powers (according to which, for example, the United States is not held to commit an expropriation when it seizes property used in the commission of a crime), this language ensures that the Police Powers and other international jurisprudence relating to expropriation is looked to, and hopefully followed, by investment arbitrators.

Confirming Letter Regarding Property Rights (Confirming Letter). The Confirming Letter, for the first time in a U.S. FTA or BIT, provides that all contract rights are property rights and thus are eligible to be investments subject to arbitration. Contract claims can involve challenges to the granting or refusing of environmental, health and safety licenses or permits, and to the acceptability of conditions on licenses and permits. Arbitral tribunals are not competent to decide these questions, which normally are decided in U.S. courts under U.S. administrative law and related jurisprudence. Moreover, many contracts are already covered under the definition of investment in the agreement, so we see no reason to further expand the reach of the arbitral tribunals and correspondingly remove all contract disputes involving foreign investors and the United States, at the whim of those investors, from the checks and balances, laws and jurisprudence of the U.S. judicial system.

Other. The Korea FTA references international law concepts as the guideposts for interpreting the substantive obligations – leaving substantial interpretive room for arbitrators to exploit. The inclusion of terms like "fair and equitable" provide arbitral panels with standards that do not exist in U.S. law. The lack of an appellate process and the lack of any oversight role for U.S. courts inhibit the development of a clear jurisprudence consistent with U.S. investor protections. There can thus be no assurance that either expropriation or minimum standard of treatment provisions will be applied in a manner consistent with the U.S. legal norms as required by the Trade Act of 2002.

II. ADDITIONAL CONCERNS WITH THE INVESTMENT CHAPTER

INVESTOR-STATE DISPUTE MECHANISMS: A THREAT TO GOOD GOVERNANCE, PUBLIC WELFARE AND THE RULE OF LAW. The dispute settlement mechanism in the Korea FTA would allow foreign corporations to sue signatory governments for perceived violations of their rights and loss of potential profits. Arbitration for these disputes takes place in secretive tribunals and often results in costly compensation paid by cash-strapped governments. In addition, the references in Article 11.16 of the Investment Chapter to the UNCITRAL rules are inconsistent with transparency and public participation, both of which are essential because of, inter alia, the fundamental issues of public policy that are the subject of investor-state disputes. There is no reason to include any other dispute settlement possibilities than the International Centre for Settlement of Investment Disputes (ICSID) and the ICSID Additional Facility, which are considerably more transparent and participatory, and there is no reason to give a private investor a choice of rules in any event.

Further tilting international investment rules in favor of investors at the expense of the ability of governments to regulate in the public interest is a threat to good governance and public welfare. The reliance on domestic courts in the first instance, and on state-to-state dispute settlement only if needed, provides more appropriate fora for protecting the rights of investors. In addition, requiring investors to rely in the first instance on domestic legal remedies helps build the rule of law by allowing national legal regimes to resolve any legitimate claims by investors. Allowing investors to remove disputes from national legal systems, as is the case in the Korea FTA, stunts the development of those systems.

The Korea FTA cannot ultimately comply 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 legitimate regulatory and other actions is a threat to good governance, public welfare and the rule of law.

REGULATORY EFFECTS NOT ADEQUATELY UNDERSTOOD. The bulk of the concerns expressed by environmental groups and others involve the regulatory effects of the investment rules. In other words, the rules and the investor-state process have been used to challenge domestic regulations designed to protect the environment and public health or advance other important social objectives. The failure to fully understand the impact of the proposed rules on domestic regulation (either domestically or abroad) undermines assertions that these agreements will support sustainable development.

EXACERBATION OF IMBALANCE. There is a continuation of an imbalanced approach to the treatment of investors (most of which are corporate actors) as opposed to citizens generally in U.S. foreign economic policy. Investors are given explicit rights and enforcement mechanisms to hold governments accountable--indeed, this imbalance is worsened by a massive shift of power to foreign investors vis-à-vis regulatory authorities. But the investment rules do not even mention, much less require, minimum standards of corporate conduct on investors acting abroad.

FAILURE TO ALLOW DISTINGUISHING AMONG INVESTORS BASED ON ENVIRONMENTAL CRITERIA. In the non-discrimination provisions (national treatment and most favored nation treatment) there is no clarity regarding the extent to which environmental criteria can be used as the basis to fairly distinguish between investors. In particular, there is no explanatory note that would ensure that future panels are guided by a notion of "like circumstances" that would accept environmental criteria as an important part of the like circumstances analysis. The classic example is in regulating point source pollution of a river. The absorptive capacity of the river system could, for example, allow five sources of pollution without significant harm, but a sixth could create too heavy a load and result in significant environmental harm. Would national treatment require the sixth facility (identical in every way to the first five, but for foreign ownership) to be compensated if it were not allowed to operate? The negotiators have demonstrated at numerous points in the text a willingness to try to provide panels with guidance, and the failure to do so here is puzzling and problematic – particularly, as noted below, when there is no general environmental exception for the investment chapter.

LACK OF ENVIRONMENTAL EXCEPTION. The failure to include a general environmental exception to the investment chapter is a further indication that international investment rules remain a significant threat to environmental and other policies enacted by governments to further the public interest. If, as the supporters of strong investment protections argue, such rules pose no threat to legitimate environmental regulations or actions of government, then why not ensure that result by clearly carving out such regulations from the ambit of the rules? The approach in Article XX of the General Agreement on Tariffs and Trade (GATT), if applied to investment, would ensure that governments are not required to compensate investors for the consequences of legitimate environmental and health regulations. As noted above, the failure to explicitly include environmental factors in the like circumstances analysis heightens the need for an effective environmental exception.

LESS FAVORABLE TREATMENT THAN IS PROVIDED TO TAX MEASURES. The Korea FTA text includes a carve-out from the expropriation provision for tax laws (Article X.3). This includes a mechanism by which the home and host countries can agree to disallow a claim for expropriation based on a tax measure. In our view, environmental and public health regulations serve societal objectives every bit as important as tax structures. The willingness to create a mechanism for governments to preclude an expropriation challenge for tax laws but not environmental laws again raises a question of whether the agreements strike the proper balance among the economic and non-economic objectives of government.

PERFORMANCE REQUIREMENTS. Performance requirements are measures that impose certain requirements on the operation of a business, e.g., that the goods it produces must incorporate a certain proportion of domestically-produced inputs, or that a certain proportion of its output must be exported. The performance requirements section of the Investment Chapter includes a puzzling environmental exception for some but not all of its provisions. The exception singles out some paragraphs and not others and directs that they not be construed in a way to prevent a Party from adopting or maintaining legitimate environmental measures. Does this mean that the paragraphs not mentioned may be construed to prevent a Party from adopting or maintaining legitimate environmental measures? If not, then why not apply the exception more broadly?

EXPANDING ARBITRAL JURISDICTION: INVESTMENT AUTHORIZATIONS AND INVESTMENT AGREEMENTS. The Investment Chapter subjects investment authorizations and investment agreements to the compulsory jurisdiction of arbitral tribunals. The magnitude and implications of these jurisdictional grants have not been adequately assessed, but it is immediately evident that they will have significant negative effects. This language undermines domestic legal systems by removing an important class of disputes from them, opens whole new areas of potential investor challenges to domestic regulatory programs, and provides foreign investors better treatment than U.S. domestic businesses have.

The investment agreements covered by them are not commercial disputes, but involve important policy questions regarding public assets, including natural resources such as oil, gas, and timber; public services, including water treatment and distribution, and power generation and distribution; and infrastructure projects, such as roads, bridges, canals, dams, and pipelines.

In particular, we are concerned about the role of the U.S. judiciary and the administration in upholding the rule of law. 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, public services, and infrastructure projects. Similarly, 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.

If it is problematic for foreign investors to take disputes over U.S. contracts and administrative and regulatory measures out of the established domestic processes designed to review them, then it is equally problematic for U.S. investors abroad to bypass the national judicial system of the host country to challenge that country's administrative and regulatory systems, absent a showing of futility. Respect for the rule of law requires that domestic legal processes be given the opportunity and responsibility to work.

The inclusion of a separate jurisdictional grant in the Investment Chapter is also unnecessary, because rights conferred by these investment authorizations and agreements are already protected, to the extent that they are included in the definition of investment, by substantive expropriation disciplines. What the new jurisdictional grants do is to make any dispute and all issues arising out of these agreements actionable for damages before unaccountable, ad-hoc arbitral tribunals.

This expansion of the investor-state arbitration is problematic, in part because these disputes can involve the collection of royalties over natural resource extraction, and because they can involve challenges to measures adopted by U.S. agencies to implement and enforce their regulations governing public services.

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