The Expropriation of Environmental Governance

Protecting Foreign Investors at the Expense of Public Policy

Summary

What do a Canadian ban on the exportation of hazardous wastes, California’s remediation requirements for open-pit mines, and the Municipality of Lima’s closure of a pasta factory have in common? They are all government measures that have been the subject of investor-state disputes resolved in international investment arbitration. The ability of foreign investors, as private actors in global politics, to sue a state in an international forum is a significant development in both international relations and international law. It challenges many of the common assumptions of traditional theories in both disciplines and has profound implications for the future of state sovereignty. Nevertheless, this phenomenon had garnered very little attention in academic or policy circles until recently.

Investors gain access to international investment arbitration through clauses in state contracts (agreements negotiated directly between an investor and a state) and international investment agreements (IIAs) (agreements negotiated between two or more states which provide protection for investors hailing from one state party and operating in the territory of another state party). The most common form of IIA is the bilateral investment treaty (BIT). The first known BIT was signed in 1959 between West Germany and Pakistan, but it is only recently that these agreements have proliferated. By the end of 2005, nearly 2500 BITs had been signed. Investment protection provisions can also be found in more than 230 regional trade and economic cooperation agreements.

Over the last decade, there has been an explosive increase of cases of investment arbitration. As of November 2006, the cumulative number of all known treaty-based investor-state disputes was 255 and at least 70 governments had faced investment arbitration. However, it is not only the number of disputes that have arisen and the number of states that have been involved that is noteworthy. The novel types of dispute that have emerged are also significant. Rather than solely involving straightforward incidences of nationalization or breach of contract, the new generation of disputes often revolve around public policy measures and implicate sensitive issues such as access to drinking water, development on sacred indigenous sites, and the protection of biodiversity.

This study explores the implications of investment arbitration for one particularly topical area of public policy: the protection of the environment. The existing literature on the relationship between investment protection and environmental protection is generally written either from the perspective of investment lawyers, who
often overlook many issues that are critical to the effective regulation of the environment, or from the perspective of environmental lawyers who are not always adequately versed in the highly specialized field of investment law. This study aims to fill this scholarly lacuna by providing a more comprehensive treatment of both investment law and environmental regulation. Furthermore, it adds a distinctly political dimension to a topic that often remains within the purview of legal studies. The guiding theoretical approach in the study is drawn mainly from international relations/international political economy scholarship, and particularly from critical studies of globalization that adopt a neo-Gramscian perspective.

**Problem Definition and Research Question**

Over the last two decades, the mantra that foreign direct investment (FDI) is vital in the effort to reduce the gap between wealthy and poor nations has become pervasive in international policy discussions. FDI is also increasingly touted as a key ingredient for the achievement of sustainable development. However, despite the uncritical approach to FDI found in many international organizations and think tanks, academic debate on the investment-development nexus is longstanding and unresolved. When the discussion is shifted to incorporate the social and environmental concerns that make up the more recent and amorphous concept of sustainable development, it is unsurprising that an academic consensus on the costs and benefits of FDI has failed to emerge.

Some scholars argue that foreign firms will use clean(er) technology and adopt home country standards or international best practices in their operations, and that positive spillovers to the domestic arena will result. Others point out that while foreign companies may be familiar with high standards and have access to state-of-the-art technology, it is too optimistic to assume that they will automatically adopt best practices in their operations in every country. Furthermore, it has been argued that even if foreign firms are relatively cleaner they are also generally larger than their domestic counterparts in developing countries, and thus have the potential to make an overall greater environmental impact.

While the debate over the relationship between sustainable development and FDI continues, it would appear that one broadly accepted conclusion that has emerged is that the regulatory context in which the investment is situated is critical. In the absence of binding global rules on corporate conduct, the national level remains the primary site for the regulation of foreign investment. However, when domestic regulation negatively impacts an investment, for example by increasing operating costs, conflicts between a foreign investor and the host state may emerge. If an investor is protected by a state contract or IIA, he may respond to such a conflict by initiating, or threatening to initiate, investment arbitration proceedings. Such actions may, in turn, have short-term and long-term implications for environmental governance.

This study examines the outcome of several cases of investor-state conflict over environmental policy. In addition to analysing the pleadings of parties and deci-
sions of arbitral tribunals in disputes that have been resolved in arbitration, the influence that investment arbitration has had in negotiated outcomes to conflicts is also explored. While conflicts in developed countries are discussed, a special focus is given to the issues and concerns that are specific to the developing world.

Against this backdrop, the overarching research question of the study is:

What implications does the protection of foreign investment through international investment agreements and state contracts have for environmental governance, particularly in developing countries?

The Institution of Investment Protection

The constitutive, regulative, and procedural norms and rules that are found in state contracts, IIAs, and sets of arbitral rules, collectively make up what is described in this study as the transnational institution of investment protection. This is a hybrid public-private institution that operates simultaneously at the international, national, and subnational levels. While the norms and rules are primarily generated by public actors (states), private actors (arbitrators) are delegated the authority to ‘interpret’ and apply these rules to specific disputes. Furthermore, private actors (foreign investors) are constituted as de facto subjects of international law capable of independently bringing a claim against a state. An investor can claim that measures taken by any level of government (municipal, provincial, etc.) are in conflict with the rules and norms of the institution, although it is ultimately the national government that assumes liability and will have to defend the measures in arbitration.

In environmentally relevant disputes, the pertinent regulative norms and rules are those covering national treatment, most-favoured-nation treatment, the international minimum standard/fair and equitable treatment, expropriation, performance requirements, stability of host country law, and observance of obligations (umbrella clauses). Procedural norms and rules concern the formation of tribunals, the conduct of arbitral proceedings, and the production and distribution of arbitral awards.

The regulative norms and rules of investment protection are decidedly vague and open to a significant degree of interpretation. There is the clear potential for environmental policy or court proceedings on environmental matters to be interpreted as conflicting with these norms and rules. However, the emergence and outcome of disputes remains difficult to predict given the broad scope for interpretation and the absence of any system of precedent. Serious procedural issues, including the lack of transparency and accountability in investment arbitration, compound this uncertainty. Furthermore, particular challenges exist for developing countries, which lack the financial and technical resources to deal with complex and costly arbitral proceedings.
Investor-State Disputes

To date a number of conflicts between investors and states related to environmental policy have been resolved in arbitration. These disputes have concerned a wide range of regulatory actions and several different environmental issues (e.g. hazardous waste, biodiversity, air/water pollution). Disputes in Canada, Costa Rica, Mexico, Peru, and the United States are discussed in the first part of the empirical portion of the study.

The decisions made by arbitral tribunals in these cases are inconsistent. Although the circumstances of each case differ substantially, this alone does not account for the divergence in tribunal decisions. This is not to claim that the circumstances of a case are immaterial, but only to suggest that the viewpoints and perspective of arbitrators are also relevant. This makes the outcome of cases more difficult for states to predict. However, despite the inconsistencies, several trends in arbitral practice are identifiable. First of all, tribunals are not likely to accept a state’s purported reasons for adopting an environmental measure on its face, but will instead assess the measure’s legitimacy. In this respect, science plays an important role, but the precautionary principle appears to be absent from the reasoning of tribunals. Another significant development is the growing acceptance of positive obligations of investment protection. Thus, protecting investment no longer solely requires a state to refrain from taking certain actions; it also mandates compliance with good governance principles such as transparency and predictability.

The cases also indicate that investment protection could potentially have consequences for multilevel governance. While investment arbitration is only accessible to national governments, a great deal of responsibility for the regulation of the environment in both developed and developing countries is delegated to subnational levels of government. This dichotomy could lead to conflict between levels of government and efforts to re-centralize power. Investment protection may also affect the implementation of multilateral environmental agreements, requiring governments to take measures that are least inconsistent with investment protection, perhaps at the expense of the efficiency and effectiveness of environmental regulation.

The Threat of Arbitration

While most research on the relationship between investment law and environmental law and policy focuses on disputes that are resolved in international arbitration, many conflicts between investors and states will likely never reach this stage. Arbitration is a high-risk, high-cost option for both governments and investors. Furthermore, states are concerned with the effect that formal disputes may have on their reputation as investor-friendly hosts. The second part of the empirical portion of the study makes a significant contribution to the literature by providing a detailed examination of investor-state conflicts that were resolved without recourse to arbitration, but where the existence of investment protection nevertheless played
an important role in the outcome. Conflicts between investors and states concerning both environmental policy (in Ghana, Indonesia, and Costa Rica) and domestic court proceedings (in Indonesia and Ecuador) are assessed. The analysis focuses on the role that the threat of arbitration played in the outcome of each conflict.

Some of the cases suggest that the existence of investment protection adds a new dimension to the regulatory chill hypothesis, which originally emerged in the context of the pollution havens debate. In addition to concerns about the exit of investors (‘industrial flight’), governments may also be wary of improving environmental regulation because of concerns that they will face costly arbitration as a result. At the other end of the spectrum, some of the cases suggest that governments might use the existence of commitments to investment protection as an excuse or political cover for its failure to improve environmental regulation. In this respect, it is important to consider the internal politics in the government, particularly in light of the fact that investment agreements are negotiated by different ministries (economic, foreign affairs) than those that deal directly with the protection of the environment. Finally, the cases concerning environmental liability show that in addition to influencing government behaviour, investment protection also has the potential to influence the decisions of domestic courts (judicial chill).

A Period of Change

The period over which this study was conducted was one of rapid development in the field of investment law and arbitration practice. The substantial increase in the use of investment arbitration has led to greater scrutiny of the regulative and procedural norms and rules of investment protection, and in some cases, to a re-evaluation of the purpose and function of these rules and norms. States, arbitral supervisory bodies, arbitrators, and NGOs have all played a role in bringing about change.

The most dramatic changes have occurred in the procedures of investment arbitration. Many arbitral awards are now made publicly available, and amicus curiae submissions to tribunals are becoming more frequent. Some countries, particularly Canada and the United States, have also revised their model BITs and have taken up the practice of conducting environmental impact assessments of new investment agreements. However, these changes are largely cosmetic and fail to address the key issues of accountability, predictability, and the capacity of developing countries to handle disputes. Furthermore, the involvement of NGOs in the arbitration process may only serve to lend the institution of investment protection an unmerited air of legitimacy.

More substantial proposals for reform, such as the development of an appellate body or a multilateral investment agreement for sustainable development, are also limited in both scope and viability. In particular, it is unlikely in the current political climate that a multilateral agreement on investment - sustainable or not - could be negotiated.

Many countries appear to be unwilling to wait for the institution of investment
protection to change, and instead have decided to opt out of it. However, the backlash against investment protection will only have implications for environmental governance if it is uniform, and not restricted to disputes over the economic returns from natural resource exploitation.

The Expropriation of Environmental Governance

With the advent of the institution of investment protection, and with the expansion of substantive norms and rules within this institution to cover aspects of environmental protection, elements of environmental governance have been taken over, or *expropriated*, by international arbitral tribunals. Arbitrated outcomes may be positive or negative from the perspective of the parties to the dispute, but the larger issue is whether tribunals should be granted the authority to regulate the regulators.

The expropriation of environmental governance by arbitral tribunals has led, or will lead, to a *loss of democratic accountability* in environmental decision-making. It is acceptable in democratic countries for domestic courts to check the power of the legislature, because the judiciary is considered reasonably free from political influence. On the other hand, as a governance system, investment arbitration is fundamentally undemocratic and its neutrality is questionable. The procedural rules and norms of investment protection were established to deal with commercial disputes where confidentiality was considered paramount, and consistency irrelevant. Such a system is inappropriate when states are involved in disputes and especially when sensitive issues of public policy, such as environmental regulation, are at stake.

The institution of investment protection has also shifted a significant degree of the risk that is inherent in foreign investment from investors to host states and has created considerable *uncertainty for regulators*. The regulative rules and norms of investment protection are ambiguous, and vary in their specific wording from treaty to treaty. When arbitral tribunals attempt to throw light upon the meaning of these rules and norms, their interpretations are controversial and inconsistent. Transparency is increasing, but confidentiality is still ubiquitous, making it more difficult for states to evaluate how disputes have been treated in arbitration. When the outcome of arbitration is uncertain, states that are faced with a threat of arbitration are more likely to settle, often at the expense of public policy.

Finally, the institution of investment protection will lead to a *decrease in the amount, and/or the effectiveness, of environmental policy* in host states. Investment protection dictates how and when states are to exert control over investors, and places limits the number of tools in the ‘policy toolbox’. Furthermore, in addition to directly castigating states, arbitrators also influence regulators and judges. Just as any good judicial system will prevent as well as punish crime, the system of investment arbitration dissuades regulatory or judicial misconduct by states. The problem is that it may also deter policy development and court proceedings that are in the interests of the public good.
Special Issues for Developing Countries

Developing countries sign the vast majority of IIAs and state contracts, and yet these countries are often poorly prepared to negotiate international agreements. In addition to signing more agreements, developing countries are often the only parties with real obligations under IIAs. In theory, inter-state investment agreements are reciprocal in that they require each state party to protect the investors of each other state party when they are operating within their territory. However, this theoretical reciprocity is not sustained in practice. This is because in the majority of investment agreements, state parties are asymmetrically related in terms of investment flows; that is, one state in the relationship exports capital, while the other(s) import capital. This is the case whether the agreement is between a developed country and one or more developing countries or economies in transition, as is the case in that majority of agreements, or if it is between two or more transition/developing economies. Instances of agreements between capital-exporting states are rare, and developed countries are not frequently exposed to investor claims.

With respect to the protection of the environment, developing countries are likely to face more investor-state conflicts than their developed counterparts because: environmental policy is more likely to change and to change more rapidly, leading to conflicts (there is a lower baseline level of regulation and considerable pressure to ‘catch-up’ with international standards); there is less coherence in national policy and thus a higher likelihood of conflicts arising between policies developed to protect investors and policies developed to protect the environment; there is a higher instance of corruption and thus investors may be given greater concessions that may in turn lead to conflicts in the future and; the courts are less respected and trusted and therefore court proceedings are more likely to be challenged for lack of due process. Furthermore, when conflicts arise it is more likely that they will be resolved in, or influenced by, investment arbitration than when comparable conflicts arise in developed countries because developing countries: have made more commitments to investment protection; cannot as easily absorb the costs of arbitration (both financial and reputational); and have a lower capacity to deal with disputes.

One could nevertheless conclude that an increase in investor-state conflicts is an acceptable trade-off for the benefits of increased flows of FDI. However, establishing a causal connection between the conclusion of an IIA and increased foreign investment flows is notoriously difficult and this issue remains highly contested in the literature. Furthermore, any gains made by developing countries in attracting investment through IIAs will be largely at the expense of other developing countries, because the system is based on competition, and thus overall welfare will not improve even if specific flows increase. Additionally there is the question of the actual benefit to the host state of increased inflows of foreign investment if they do materialize. In particular, there is the issue of the value of foreign investment in the form that is promoted in IIAs and state contracts, given the fact that these
agreements seem to emphasize the encouragement of foreign investment as if it were an end in itself, rather than a means to achieving sustainable development.

**Contribution to Theory**

The institution of investment protection is viewed in this study as a key component of what neo-Gramscians call the ‘new constitutionalism’. The new constitutionalism encompasses the structural and ideological constraints that are imposed on states by a transnational historic bloc made up of corporate and governmental elites. The concept helps to explain why states are voluntarily ceding authority to tribunals and it also captures the way in which the constraints of investment protection can be ‘locked-in’, resulting in a loss of democratic accountability.

The study benefited from the application of neo-Gramscian insights and it also, in turn, contributed to neo-Gramscian scholarship. While the major writings in the field are largely focused at the macroeconomic and macropolitical level, this study focused on one specific area and gave considerable attention to domestic interactions. The study also drew links between neo-Gramscian theory and other theories/hypotheses (e.g. regulatory chill, political cover). These hypotheses and theories are consistent with neo-Gramscian thought and both enrich and help to operationalize a neo-Gramscian framework.

**Recommendations**

Absent the creation of an entirely new mechanism of investor-state dispute settlement, such as an investment court, it would seem that the most sensible option for governments is to restrict access to arbitration to states only, and provide investors recourse to only domestic remedies. In addition to (or in lieu of) avoiding the current system of investment arbitration, reference to the international minimum standard/fair and equitable should not be included in new IIAs. The standard is simply too broad and has been interpreted too expansively by tribunals. Furthermore, state contracts, if they are to be employed by states, should not include stabilization clauses. Given the fact that in many developing countries environmental regulation of foreign investment is minimal to begin with, agreeing to general or specific commitments to stability of the environmental regulatory framework could lock a country into deteriorating environmental conditions.

When drafting IIAs and state contracts, governments should ensure that it is explicitly stated that the purpose of these agreements is to promote and protect investment that contributes to sustainable development. However, considering the amorphous nature of this concept, governments should also incorporate in the text of IIAs the most important and relevant principles of international environmental law. Additionally, states should increase transparency and participation in contract and treaty negotiation. Developing countries should also make efforts to cooperate to a greater extent on investment issues to avoid the bidding wars that competition for investment can create. Finally, international organizations, research institu-
tions, lawyers, NGOs, and states should collaborate to create a legal assistance centre for developing countries.