

Article

Investor–State Dispute Settlement and Sustainable Development: Negative Externalities and a Need for Reform

Haden Choiniere¹, Vladislav Maksimov¹

¹ University of North Carolina at Greensboro, USA

Keywords: investor-state dispute settlement, regulatory chill, negative externality, sustainable development

<https://doi.org/10.46697/001c.32976>

AIB Insights

Vol. 22, Issue 1, 2022

Investor–state dispute settlement (ISDS) is designed to encourage foreign investment by mitigating risks to investors. However, the use of ISDS provisions by MNEs also creates negative externalities for states’ efforts at sustainable development by provoking regulatory chill on enforcement of current and enactment of future regulation. We illustrate these externalities of the current arbitration system with four cases and other examples. We conclude with recommendations to policymakers for ISDS reform that will mitigate these negative externalities and promote sustainable foreign investment by redefining investments to include sustainable development criteria, including representation of third-party stakeholders, and creating accountability for investor obligation.

INTRODUCTION

Investor–state dispute settlement (ISDS) exists to protect the mutual interests of foreign investors and host states. It resolves a key strategic tradeoff for multinationals considering whether to engage in foreign investment. Multinationals can tap into new markets, obtain access to key resources, realize economies of scale, and improve global competitiveness. Host nations also welcome foreign investment because it can facilitate their economic development, a priority for many developing countries. However, foreign investment carries a significant risk of expropriation and discrimination, especially in less economically developed countries. ISDS is designed to encourage foreign investment by mitigating potential risks to investors and protecting against expropriation from host governments without due compensation. The mechanism provides investors with recourse through international arbitration tribunals when operating under the jurisdiction of a foreign government.

Unfortunately, in its present form ISDS produces negative externalities that can undermine global efforts toward sustainable development. ISDS offers a legal opportunity for foreign investors to contest national regulations aimed at sustainable development and demand compensation on the grounds of expropriation and discrimination claims. For example, the French Veolia filed a suit against Egypt for the minimum wage raise in Alexandria and the Canadian Methanex, a methanol producer, filed a suit against the US for an executive order issued by the governor of California to gradually remove a methanol-based gasoline additive in the state.

ISDS CASES ON SUSTAINABLE DEVELOPMENT REGULATION

To assess the weaknesses of ISDS in the context of sustainable development and find a solution in the interest of both sides, we examine four cases related to sustainable development regulation. Specifically, Philip Morris’s case demonstrates the damages to states even when ruled in their favor, Cortes’s case shows the potential risks of adopting new sustainability regulations, Tecmed’s case underscores the conflict between inward FDI and sustainability concerns, and Chevron’s case highlights the importance of third-party representation in investor–state disputes.

PHILIP MORRIS V. URUGUAY (2010), IN FAVOR OF THE STATE

In 2010, Philip Morris (PM) began proceedings in 2010 against Uruguay for introducing tobacco industry regulation that banned the sale of different products under the same brand and required larger health warnings on packaging. PM alleged expropriation and denial of fair and equitable treatment (FET) standards amounting to decreased company value and deprivation of intellectual property rights. PM sought either repeal of or exemption from the regulations or damages of at least \$22.267m plus compound interest and arbitration costs. Uruguay contended that the measures were enacted for all tobacco companies in the interest of public health (*Philip Morris v Uruguay*, 2010).

The tribunal found that the measures were reasonable and non-discriminatory, relying on a substantial body of evidence regarding the dangers of tobacco consumption, and hence FET standards were not violated. Expropriation of profits or intellectual property was also dismissed. The proceedings lasted almost six years and the dispute cost

Uruguay \$10.3m, though PM was ordered to repay \$7m. Although the tribunal reaffirmed the police powers of the state to regulate in accordance with public health, the case demonstrates the possible scope of damages and cost that can be extracted from the state via ISDS.

CORTEC MINING KENYA LIMITED V. REPUBLIC OF KENYA, IN FAVOR OF THE STATE

Cortec Mining sued Kenya for direct expropriation of their Special Mining License in 2013 after investing millions in the project. Kenya's respondent claim was that the mining company failed to prove the investments were covered by the bilateral investment treaty (BIT) and that the license was unlawful for failing to have acquired necessary approvals according to preexisting state law, specifically an Environmental Impact Assessment license. Their license was granted illegally by the Mining Commissioner, who circumvented state law. The tribunal ruled in the state's favor, concluding that the BIT protects only lawful investments (*Cortec Mining v Kenya*, 2015).

The determining factor was the existence of a covered investment under the treaty. If Kenya did not have an established law requiring an environmental license and had adopted one later, the investment could have been considered lawful. The case demonstrates the potential dangers to the state from adopting sustainability legislation.

TECNICAS MEDIOAMBIENTALES TECMED S.A. V. UNITED MEXICAN STATES (2000), IN FAVOR OF THE INVESTOR

Tecmed, a subsidiary of a Spanish firm, purchased a hazardous waste landfill in 1996. They received a permit to operate on a yearly, renewable basis. During its operations, Tecmed was fined for violations of environmental protection regulations at the site and waste-transportation activities. Newer regulations also placed the landfill's location too close to a population center and after local pressure, Tecmed agreed to relocate to a better position. However, Mexico refused to renew their permit, halting further operations. Tecmed then filed for arbitration against Mexico, arguing for direct expropriation of their investment, constituting an arbitrary act in violation of the FET standard set by the Spain-Mexico BIT (*Tecmed v Mexico*, 2000).

The tribunal ruled in favor of Tecmed, allowing that Mexico both expropriated the investment by revoking the permit and violated the FET standard. Tecmed's expected investment was long-term, despite the year-to-year nature of the permit, and therefore, denial of renewal constituted an expropriation. The state's actions were determined to be insufficiently motivated by environmental or public health concerns. This case underscores the relative weight of direct expropriation over environmental concerns and other contractual clauses. Although the state documented environmental and health concerns, these were all superseded by the investment amount.

CHEVRON CORPORATION AND TEXACO PETROLEUM V. ECUADOR (2009), IN FAVOR OF THE INVESTOR

Texaco Petroleum (TexPet) operated a subsidiary in con-

junction with the local Ecuadorian Gulf Oil Company. A Concession Agreement in 1973 granted them rights to oil exploration and extraction in the Lago Agrío region of the Ecuadorian Amazon. TexPet divested their portion in 1990, ceasing activity in the region. Chevron then became an indirect shareholder of TexPet in 2001. In 2003, indigenous Ecuadorians filed legal proceedings against Chevron in the local court for harmful pollution. Chevron was ordered to pay damages and the Ecuadorian Supreme Court later upheld the decision. Following the Ecuadorian court ruling, Chevron initiated ISDS arbitration proceedings alleging that the liability for environmental impacts lay with Ecuador and PetroEcuador for their part in the joint operations based on the concession agreement. Indeed, TexPet, PetroEcuador, and Ecuador signed a settlement agreement in 1998 absolving TexPet of liability for claims by the government, PetroEcuador, or affiliates (*Chevron v Ecuador*, 2009).

The tribunal ruled in favor of Chevron based on the agreement releasing them from liability, despite the local rulings to compensate citizens for environmental damages. In this case, the state traded inward FDI for stricter environmental regulation and betrayed the interests of its citizens in the Lago Agrío region. ISDS provisions gave Chevron recourse against a sovereign state's court rulings and effectively excluded the affected stakeholder, whose interests were not represented by the state.

NEGATIVE EXTERNALITIES

The four cases demonstrate that ISDS unintentionally allows MNEs to seek protection from or compensation for regulation intended to advance sustainable development. In doing so, ISDS creates negative externalities by way of regulatory chill on sustainable development policies (Janeba, 2019; Tienhaara, 2018). We distinguish between regulatory chill in enforcement and enactment of good faith regulations. First, ISDS provisions unintentionally create an explicit cost of enforcing sustainable development regulations. The award settlements ruled in favor of the investor have risen over the past decade, meaning states face increasingly prohibitive damages. For example, Pakistan was recently ordered to pay Chilean Canadian firm Tethyan over \$4b in damages over the firm's investment of just over \$220m (Van der Mewe, 2020). Yet, even when cases are settled or decided in their favor, states end up incurring millions in arbitration costs.

Second, anticipated difficulties and costs of enforcement create uncertainty with respect to future enactment of sustainable development policies by states. When statutory claims of prior ISDS cases are applied unpredictably, governments receive an unclear signal that prevents them from judging independently whether their future policies will be in accordance with the applicable IIA, therefore deterring or postponing such actions (Schram, Friel, VanDuzer, Ruckhert, & Labonté, 2018). For example, in 2017, France softened its proposed ending of extraction permit renewals by 2030 to 2040 after energy firm Vermillion threatened arbitration (Van der Mewe, 2020). Additionally, uncertainty associated with ISDS has driven some states to retaliate. For example, Canada pulled itself out of the ISDS clause

in the new United States–Mexico–Canada Agreement. While such action frees the state to enact sustainable development policies, it has the downside of discouraging FDI, which in turn could limit the capacity of the state to bring about sustainable development.

At the heart of the problem is the legal foundation for filing ISDS arbitrations. The primary allegations are expropriation, breaches of FET treatment, and arbitrary, unreasonable, and/or discriminatory measures (UNCTAD, 2021). Although direct expropriation is relatively clear-cut, most expropriation allegations are indirect. Whether indirect expropriation has occurred depends on the facts and the treaty language, and on how both are interpreted by the dispute settlement body. Similarly, the FET obligation under IIAs is particularly nebulous (Malik, 2009).

ISDS REFORM

To mitigate these negative externalities, ISDS can be reformed to include sustainable development considerations and avoid potentially severe social and environmental ramifications from the current system. An ISDS reform should address three key issues: sustainable foreign investment, local stakeholder representation, and investor accountability.

SUSTAINABLE FOREIGN INVESTMENT

The traditional ISDS framework does not require an investment to be sustainable to be protected under a treaty. To balance investor protection with the need for sustainable development, IIAs should define foreign investments based on investor obligations to minimum sustainability standards and according to the sustainable development goals of the host nation. Such an adjustment to the definition of a covered investment will reduce the incentives of multinationals to resort to ISDS when the actions of the state are motivated by a sustainable development agenda that is consistent with the provisions laid out in the IIA. These provisions can be grounded in ILO Conventions, the Paris Agreement, or UN SDGs.

Moreover, IIAs that incorporate a ‘contribution to the development of the host state’ criterion in defining covered investments can be expanded to require a ‘contribution to sustainable development’ criterion (e.g., Sauvart, Stephenson, & Kagan, 2021). Such an addition can directly incentivize multinationals to conduct sustainable FDI. Rather than being an extra cost, the sustainable development requirement can be in the interest of the foreign investor. Multinationals can internalize competitive benefits in two ways: create positive externalities for host nations by investing in greater knowledge, wealth, and health and lessen negative externalities through investments to reduce the overuse of natural resources, harm to social cohesion, and overconsumption (Montiel, Cuervo-Cazurra, Park, Antolin-Lopez, & Husted, 2021).

LOCAL STAKEHOLDER REPRESENTATION

Current ISDS clauses provide foreign firms with legal recourse that is denied other stakeholders such as domestic

firms or local populations that can be subject to corrupt or flawed governments. To mitigate the negative externality from poor national governance, sustainable development provisions in ISDS should allow for representation of affected local stakeholders (Sachs, Johnson, & Merrill, 2020). This amendment will aid third parties in suing multinationals for violating their investor obligations. It will also serve to protect the national sovereignty of vulnerable populations, mitigate the marginalization of voters, or reduce the risks from overruling the separation of powers by taking the responsibility for policing investor actions away from states, which could be dependent on inward FDI for development.

INVESTOR ACCOUNTABILITY

Incorporating investor obligations for sustainable development in IIAs requires a specific mechanism for enforcement that allows for complaints on alleged violations of sustainable development commitments. Such a mechanism is needed to protect the interests of both multinationals and host nations. It can be implemented either within the ISDS arbitration system or by incorporating it into the role of existing human rights tribunals. For example, the new EU–China Comprehensive Agreement on Investment includes a mechanism for reporting of violations that serves to encourage market access for business and protect sustainable development goals (European Commission, 2020).

CONCLUSION

The traditional intent, design, and implementation of ISDS create negative externalities by way of regulatory chill on sustainable development policy around the world. To make ISDS mutually beneficial for foreign investors and host nations, an improved and unified system of arbitration is needed that provides for sustainable development considerations in foreign investment. Effective reforms to ISDS require adapting IIAs more broadly. We call on policymakers to push for ISDS reform addressing the need for a new definition of lawful investment, representation of affected stakeholders, and accountability for investor obligations. Used effectively, reformed ISDS could help shape a future of foreign investments that promote sustainable development.

ABOUT THE AUTHORS

Haden Choiniere (lhchoiniere@icloud.com) has an MS in International Business from the University of North Carolina at Greensboro, an M2 in History from the Université de Paris La Sorbonne, and a BA in History from the University of South Carolina Honors College. Her interest lies in sustainable development in governance and international business with an appreciation for the complex history that underpins the modern paradigm.

Vladislav Maksimov (vmaksim@uncg.edu) is a graduate of the University of Miami (PhD), Ohio University (MBA), and Sofia University (BBA). He is an Associate Professor

of Strategy and International Business at the University of North Carolina at Greensboro. He is interested in the interplay between institutions and organizational capabilities in international business. His current research focuses on the role of business organizations in solving society's most pressing environmental and social challenges.

Submitted: September 13, 2021 EST, Accepted: February 17, 2022 EST



This is an open-access article distributed under the terms of the Creative Commons Attribution 4.0 International License (CCBY-4.0). View this license's legal deed at <http://creativecommons.org/licenses/by/4.0> and legal code at <http://creativecommons.org/licenses/by/4.0/legalcode> for more information.

REFERENCES

- Chevron Corporation and Texaco Petroleum Corporation v. Ecuador (II). 2009. *PCA Case No. 2009-23*.
- Cortec Mining Kenya Limited v. Republic of Kenya. 2015. *ICSID Case No. ARB/15/29*.
- European Commission. 2020, November 16. *Commission launches new complaints system to fight trade barriers and violations of sustainable development commitments (Press release)*. https://ec.europa.eu/commission/presscorner/detail/en/ip_20_2134.
- Janeba, E. 2019. Regulatory chill and the effect of investor state dispute settlements. *Review of International Economics*, 27(2). <https://doi.org/10.1111/roie.12417>.
- Malik, M. 2009. Fair and Equitable Treatment. *International Institute for Sustainable Development Best Practices Series*. <http://www.iisd.org/publications/fair-and-equitable-treatment>.
- Montiel, I., Cuervo-Cazurra, A., Park, J., Antolin-Lopez, R., & Husted, B. 2021. Implementing the United Nations' Sustainable Development Goals in international business. *Journal of International Business Studies*, 52(5): 999–1030.
- Philip Morris v. Uruguay. 2010. *ICSID Case No. ARB/10/7*.
- Sachs, L. E., Johnson, L., & Merrill, E. 2020. Environmental Injustice: How Treaties Undermine Human Rights Related to the Environment. *La Revue Des Juristes de Sciences Po*, 18: 90–91.
- Sauvant, K., Stephenson, M., & Kagan, Y. 2021. Green FDI: Encouraging carbon-neutral investment. *Columbia FDI Perspectives*.
- Schram, A., Friel, S., VanDuzer, J. A., Ruckhert, A., & Labonté, R. 2018. Internalisation of International Investment Agreements in Public Policymaking: Developing a Conceptual Framework of Regulatory Chill. *Global Policy*, 9(2): 193–202.
- Técnicas Medioambientales Tecmed S.A. v. United States of Mexico. 2000. *ICSID Case No. ARB(AF)/00/2*.
- Tienhaara, K. 2018. Regulatory chill in a warming world: The threat to climate policy posed by investor-state dispute settlement. *Transnational Environmental Law*, 7(2): 229–250.
- UNCTAD. 2021. *Investment Dispute Settlement Navigator*. <https://investmentpolicy.unctad.org/investment-dispute-settlement>.
- Van der Mewe, B. 2020. *Why Investor lawsuits could slow the energy transition*. Energy Monitor.