Kluwer Arbitration Blog

Are Investment Treaties "Zombies", Unfit for Decarbonization Purpose?

Jorge Guira (University of Reading) and Maria Beatriz Burghetto (Independent Counsel and Arbitrator) · Monday, August 1st, 2022

States' international obligations to reduce emissions, on the one hand, and to protect foreign investment, on the other, suggest a collision course between climate activists' desires and foreign investors who rely on treaty protection to safeguard their investments.

Recent investment treaties, especially bilateral investment treaties (BITs) have tended to expand the rights of States to police environmental and labor harms. Whether they have kept up with the Environmental Social Governance (ESG) movement, the Paris Agreement, and post-Conference of Parties (COP) 26 developments raises considerable questions. Specifically, to what extent are past treaties themselves Zombies, unfit to accomplish the Paris Agreement's Objectives of reducing emissions to reduce climate change to less than 2° Celsius?

Background

The 2022 agreed-upon-in-principle modernization of the Energy Charter Treaty (ECT) has attempted to address this costly dilemma. Two key elements stand out:

One, a "flexibility mechanism" whereby Contracting Parties – based on an ECT Conference's decision – could "exclude investment protection for fossil fuels in their territories, considering their individual energy security and climate goals". Two, a stand-alone clause reiterating and strengthening "the right of Contracting Parties to regulate within their territories (…) in the interest of legitimate public policy objectives (which) may include the protection of the environment, including climate change mitigation and adaptation", etc. It is not clear whether this right to regulate will exonerate a host State from liability. Absent an express exclusion of liability, clauses reiterating the State's power to regulate in certain areas may not carry such effect.

This starkly raises questions as to whether numerous existing BITs and other Treaties with Investment Provisions (TIPs) should be assessed for perceived structural defects or extant conflicts. Such exercise could create conflict or tensions with foreign investment protection, given the Paris Agreement and related laws, as well as climate and ESG movement awareness and related events.

Importantly, recent treaties (and model treaties) already appear to be more inclusive of States' concerns regarding protecting the environment and mitigating climate change, although the two aspects may not be identical concepts. Earlier investment protection treaties (or rules), however,

typically impose no or few environment or climate change-related obligations on foreign investors. Climate change mitigation and adaptation laws and norms may therefore clash with protected rights of foreign investors. This could raise two potentially central issues for arbitral tribunals to potentially contend with, i.e., jurisdictional maneuvering and applicable law positioning.

Lastly, it highlights the fact that the discussion on the supremacy of international law over domestic law or, generally, the interaction of these two systems, is an ongoing one, and of strong potential relevance.

From Old to Modern

The interrelated law and public policy aspects point to two questions: How will investment treaties hold up as an instrument under the scrutiny of climate activists? Are these treaties indeed fit for purpose in a world in which social costs are argued to require recalibration to include climate protection?

Prior treaties, with a range of generations and language choices within each reflect more consideration of climate-related aspects over time. How this plays out in individual cases depends, and is likely to become more contentious as climate costs loom larger.

Reformed treaty drafts, given varying bargaining and costs, could also default to the middle path of constructive ambiguity to position themselves between alignment and arbitrage. This may accommodate various interests in architecture, but also potentially leave troubling gaps for arbitral tribunals to fill. This may even apply to the ECT modernization reform, depending on language and interpretative rules used.

In ISDS practice, notions of economic harm are impacted by evolving understandings of the environmental and climate interplay, and laws regarding the scope and definition of what is considered materially relevant.

Alignment, Ambiguity, Arbitrage in Treaty Architecture

Treaties are structured as compromises between competing interests. Earlier generation BITs typically focused more on safeguarding legal certainty so that capital flows of foreign investment could thrive in the host State. The assumption was that the host State's judicial institutions could treat foreign investors in an unfavorable manner and was also based on concerns about various expropriation types and fair and equitable treatment over the life of an investment. Recent investment treaties (i) expand the host State's regulatory powers, in order "to achieve legitimate policy objectives", which expressly includes regulations "addressing climate change and (ii) dissuade States from relaxing domestic health, safety or environmental measures in order to attract foreign investment. Some model BITs, such as the Colombia Model BIT 2017, go further, by expressly designating as mandatory rules all "prohibitions established in international instruments, to which any Contracting Party is or becomes a party, pertaining to human rights and the environment".

Still, this challenges the evolving concerns of climate activists as harm is typically foreseeable in the future, but – it is argued – may not have been contemplated in past "deals". On the other hand, a narrower concern of the host State's right to regulate could restrict State action to varying degrees, causing regulatory chill.

Public Policy: Interpretations, and the End Game

Much of the climate agenda is about how society absorbs the social costs of paying for decarbonization (Who pays?). At present and for many years, ISDS has increasingly come under scrutiny as a legal and economic institution that may not produce just societal outcomes. If treaties are viewed only or primarily as vehicles for compensation to corporations, it becomes open to the view that it is structurally speaking, a protection racket for MNC's or a creature of dependent development. On the other hand, host States' arbitrary and harmful conduct against foreign investment has been proven time after time, and MNCs may consequently draw inward toward friendlier locales, ignoring jurisdictions with too high a financial cost, if perceived as too geopolitically risky.

The persistent tension between foreign investment protection and a costly decarbonization is likely to expand. The challenge for decision-makers is how to maintain the relevance of the former as a remedy to facilitate investment that serves both States' interests and those of foreign private investors. Absent specific rules/guidelines concerning interpretation and application of BITs, such as interpretative protocols signed by the parties to a BIT, for example, or "subsequent practice" between two given States, as per Article 31.3(b), Vienna Convention on the Law of Treaties (VCLT), a "gap" seems presented.

Treaty architects and arbitrators must consider the risks of this evolving situation from their own perspectives. Issues such as sunk costs, rents/corruption, foreseeable harm and treaty language, the scope of ESG, parent-subsidiary relationships and liability, and evolving concepts of attribution science, and of legal, accounting, and sustainability components of material economic harm are implicated here.

The 1969 VCLT, which favors harmonization and systemic integration of applicable international rules, may offer a way out. This is provided arbitrators adopt an expanded notion of public international law, by applying treaties and sources of international law other than the BIT at hand.

Such sources, together with other agreements and practices between the State parties on the interpretation of the BIT in question, form part of "the relevant rules of international law applicable in the relations between the parties" to which Article 31.3(c) of the VCLT refers when it provides such rules must be taken into account when interpreting a treaty.

In practice, however, arbitrators tend to adopt a narrower, more conservative, approach, to avoid overstretching their jurisdiction under the applicable BIT. Indeed, to promote legal certainty, arbitral panel decisions should be narrowly tailored; otherwise, the bargained-for interests and expectations of the corporations investing in foreign, especially developing countries, for example, can be violated.

Public policy considerations may pose important consequences for investors. Climate change mitigation / adaptation obligations undertaken by States may be deemed to be part of the host State's international public policy, or even transnational public policy. As such, could it be ignored by arbitrators, with increased risk that their awards are set aside or not enforced against the host State? This can create genuine legitimacy dilemmas between traditional strict constructionists and those arguing legitimacy is threatened if public policy is not even considered.

In addition, States' counterclaims, as allowed by Article 46 of the ICSID Convention, are tools that may be used to restore some balance in ISDS, by enforcing investors' sustainability obligations, as

some cases show. Pending any possible reform of ISDS, systemic integration of international investment law by arbitrators could help achieve this goal.

Exit, Voice, or Loyalty

States are grappling more with climate change. The arbitration community and policy makers must strongly consider investments and capital flows that are incentivized and balanced, given legacy agreements, and reconcile them with greater awareness and demands for climate and environmental protection.

Consideration of alternate remedies and limits therein may be crucial, including litigation for various stakeholders who may have interests allied with climate but may not have standing or interests that can best, or indeed at all, be pursued through investment arbitration.

This increasingly poses the question whether litigation, which was once the alternative to avoid which arbitration was established for, becomes an inescapable route to redress. The arbitration community should ask itself whether it wishes that investment arbitration becomes *more relevant* or continues to be perceived by some as an asymmetrical tool that is useful for MNCs, but perhaps less so for the population.

Sum

Our objective has been to show that investment treaties can pose “Zombie risk” as to ongoing decarbonization concerns. Arbitrators, together with party counsel, corporate foreign investors and climate activists should consider the implications of this, including the ECT modernization law reform approach.

Foreign investment protection should not be demonized, nor should it be foregone at the expense of climate change mitigation/ adaptation policy.

Key investment and climate law actors must also consider how climate has already and will in future impact treaties and ongoing disputes, so that each set of legitimate interests, i.e., those of foreign investors and those of respective affected population groups, as well as collective actors, have a voice to better resolve sometimes diverging energy investor and climate policymaker concerns.

This entry was posted on Monday, August 1st, 2022 at 8:02 am and is filed under Environment, ISDS Reform
You can follow any responses to this entry through the Comments (RSS) feed. You can leave a response, or trackback from your own site.