Kluwer Arbitration Blog

Much Ado About Nothing? – Advocating for Legality Clauses instead of ESG and CSR Investor Obligations in International Investment Agreements

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The growing antagonism in civil society and the asymmetries in international investment agreements (IIA) lead to a cautious proliferation of enforceable obligations against investors (investor obligations) in several newer IIAs (e.g. Chapter 6-10 of ECOWAS Common Investment Code 2018; Art. 10 and Annex II of Angola-Brazil Bilateral Investment Treaty (BIT) 2015; and for an overview of current investor obligations *Bueno*/*Yilmaz Vastardis*/*Ngueuleu Djeuga*, "Investor Human Rights and Environmental Obligations: The Need to Redesign Corporate Social Responsibility Clauses" SSRN).

This blog post will, firstly, set out the benefits of the inclusion of investor obligations generally, then distinguish between different categories of investor obligations. After discussing the drawbacks of Corporate Social Responsibility (CSR) and Environmental, Social and Governance (ESG) investor obligations, the post will put forward its own proposal of a legality clause with a "sustainable-development" element.

Overall Benefits of Including Investor Obligations

Investor obligations constitute a shift from the traditional IIA framework of unilateral host State obligations protecting investments towards the rebalancing of investment obligations.

From the perspective of host States, investor obligations help them overcome the procedural issue of connexity, enabling them to bring counterclaims (see Hesham T. M. Al-Warraq v Republic of Indonesia, UNCITRAL, Final Award (15 December 2014), para. 667).

Moreover, the risk of counterclaims may compel investors and third-party funders to assess an investor's conduct more holistically before initiating or financing an arbitration. It further creates incentives for investors to better comply with global public interest regulation because compliance decreases the risk of meritorious counterclaims in the course of the arbitration (so-called counterclaim-chill – to keep the analogy to the regulatory chill).

Regarding procedural efficiency, simultaneous resolution of all disputes including the counterclaims by an arbitral tribunal prevents duplication of proceedings, is cost-effective, and

ensures neutrality of the dispute forum, which is essential to investors.

The legal consequence of failure to adhere to an investor obligation included in an IIA could be one of the following: denial of access to dispute settlement, mandatory performance of the obligation, or compensation in lieu of performance paid to the host State (e.g. Art. 18 IISD Model 2005).

The Drawbacks of CSR and ESG Investor Obligations

While the recent debate, on the Kluwer Arbitration Blog and elsewhere, has either been broad (e.g. here, here and here) or examined specific IIAs incorporating investor obligations (here for India and here for Morocco), it has not addressed the normative issue of identifying which category of investor obligations is preferable. This contribution seeks to shed light on this question.

Investor obligations can be broadly categorised as legality clauses (e.g. Art. 7 para. 1 Netherlands Model BIT 2019), CSR clauses (e.g. Art. 14 Brazilian Model CFIA 2015), and ESG clauses (e.g. Art. 11-18 IISD Model 2005). ESG clauses regulate specific investor conduct themselves by providing for new obligations, while legality clauses or CSR clauses refer to external frameworks, such as national law or the OECD Guidelines for Multinational Enterprises on Responsible Business Conduct ("MNE Guidelines"). While legality clauses are frequently invoked in arbitration, other investor obligations are rarely litigated before arbitral tribunals.

Focusing on the disadvantages of CSR and ESG investor obligations, firstly, it must be mentioned that their inclusion imposes additional obligations on investors, potentially deterring them due to the added administrative burdens.

For instance, the South African Development Community Model BIT Template mandates investors to conduct an environmental impact assessment (Art. 13.1 SADC Model BIT Template), despite acknowledging that "virtually every State" (*SADC*, SADC Model Bilateral Investment Treaty Template with Commentary (Southern African Development Community, 2012), p. 34) already has such provisions in place. As a result, the investor obligation only increases the administrative burden on the investor without delivering significant added value in protecting global public interests. This lack of added value of the investor obligations is amplified by other regulatory measures already applicable to investors, such as home State laws (e.g. EU Mandatory Human Rights Due Diligence) or guidelines by multinational fora (e.g. OECD MNE Guidelines).

Imposing obligations stricter than national law via CSR and ESG clauses could lead to unjustifiable discrimination between national and foreign investors. Such discrimination could in turn violate fundamental rights of the investor but also anti-discrimination standards in the IIA. Any justification is likely to fail since it is not readily explainable why similar-sized companies would behave differently solely due to their nationality.

Coherency issues may arise when CSR and ESG clauses apply double standards by imposing obligations on investors at levels beyond the host State's commitment. For example, Art. 18 para. 3 Morocco-Nigeria BIT requires investors' compliance with the International Labor Organization ("ILO") core labour standards while Morocco itself did not ratify the ILO Convention on Freedom of Association.

Furthermore, the inclusion of investor obligations does not in itself promote domestic supervision and enforcement mechanisms of these obligations without corresponding national law. Rather, it only serves as a procedural vehicle to demand compensation from the investor. Instead, the host State requires a strong national regulatory framework equipped with capable and effective domestic institutions to continuously protect global public interests. Absent these domestic mechanisms, when an investor initiates arbitration, the Contracting State might engage in a witch hunt and launch investigations to discover investor non-compliance purely to also claim damages.

Moreover, international agreements between States lack legal certainty in that they are inherently vague, overlap with national law, and hence create unnecessary regulatory complexity when CSR and ESG clauses apply to investors. Adding clauses that apply home State law, in addition to host State's law, might complicate matters without providing significant benefits (e.g. Art. 12 para. a IISD Model 2005). Especially in multi-jurisdictional corporate structures several slightly different but essentially similar regimes would need to be complied with.

In summary, while investor obligations generally follow the laudable goal of increasing the protection of global public interests and fostering the procedural stance of the host States, CSR and ESG clauses seem to multiply the administrative burden of the investor, without adding value, while depriving the host State of the opportunity to develop sufficient domestic supervision and enforcement mechanisms. The inclusion of such clauses appears to "protect" host States from "bad investors", thereby making the sole purpose of an IIA in attracting investors redundant.

Instead, a Legality Clause with a "Sustainable-Development" Element?

As criticizing without offering solutions is too easy, the author proposes instead the reliance on an "old-fashioned" legality clause requiring ongoing compliance with national law (similar to Art. 9 OIC Agreement 1981 as examined in Al-Warraq v Indonesia, paras 157 and 645). The legality clause serves as link between the IIA and the domestic law, making violations of the latter actionable in the arbitration.

To prevent even minor transgressions from falling under the clause, a threshold-requirement of serious violations could be introduced. This is not only more cost-sensitive but also prevents stalling tactics of the Contracting States by flooding the arbitration with minor transgressions.

To further narrow the scope of the legality clause, a list of specified areas of law can be included, either by declaring that it particularly or exclusively applies to violations within these areas (e.g. Art. 7 para. 1 Netherlands Model BIT 2019).

Hereby, the Contracting State may bring counterclaims without the IIA imposing additional administrative burden on the investor. Due to regard solely to national law, legal certainty is upheld. With the focus solely on national law and domestic supervision and enforcement procedures, the domestic legal system and its rule of law will be nurtured. This could be reinforced if the arbitral tribunal would be required to have due regard to the corresponding domestic jurisprudence and practice when applying national law (similar to Art. 8.31.2 CETA).

Further, due to its current widespread usage, a legality clause (even if modified as proposed) might be met with less fierce resistance than novel CSR and ESG clauses have in drafting a treaty.

The major drawback of not including ESG and CSR clauses is that host States with lax regulations may attract exploitative investors. To address this concern and to strengthen national law, the legality clause should be upgraded with a “sustainable-development” element.

This element would oblige Contracting States to implement specified international instruments. Further, it could include promotion of information and knowledge sharing, development of common practices, and procedures to track the progress of implementation.

Since the element would resemble “Trade-and-Sustainable-Development” chapters in trade agreements, lessons learned from that context could inform drafting, implementing, and enforcement of this clause. It is essential to respect the regulatory and developmental circumstances of the Contracting States to ensure practical and achievable implementation, without setting unrealistic goals for the Contracting States.

Conclusion

To sum up, such a double-pronged approach focused on compliance with national law (via the legality clause) as well as strengthening national law (via the “sustainable-development” element) reduces the burden on investors, while promoting global public interests as well as strengthening the rule of law, and is hence better suited as investor obligation than CSR and ESG clauses.

This entry was posted on Tuesday, January 30th, 2024 at 8:29 am and is filed under Corporate Social Responsibility, ESG, International Investment Arbitration, Investor duties
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