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ISDS and ESG: Friends or Foes?

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Traditionally, investor-state dispute settlement ("**ISDS**") has not been linked to Environmental, Social, or Governance principles ("**ESG**"). At least not explicitly. Nevertheless, a growing number of arbitrations revolve around matters like environmental permits, green incentives, the need for a "social license," and corruption. Interestingly, these matters have arisen even in the absence of explicit ESG regulations in the majority of the older generation of international investment agreements ("**IIAs**").

Skepticism surrounds the relationship between ESG and ISDS, however. In a recent report titled "Paying polluters: the catastrophic consequences of investor-State dispute settlement for climate and environment action and human rights" (the "**UN Report**"), the UN Special Rapporteur on Human Rights and the Environment cautioned that ISDS hinders climate action and human rights protection, resulting in a "regulatory chill." (UN Report, ¶¶ 49-52) The UN Report characterizes ISDS as a force "perpetuating extractivism and economic colonialism" (UN Report, ¶ 8), benefitting primarily the fossil fuel and other extractive industries (UN Report, ¶¶ 3-9). Similarly, *Soubeste and Others v. Austria and 11 Other States*, a pending case before the European Court of Human Rights, will examine whether the Energy Charter Treaty ("**ECT**") impedes states from achieving goals outlined in the Paris Agreement on climate change.

As demonstrated in this post, these critiques are misguided. Sustainable development requires resources, which foreign states can access through foreign investment. Without robust substantive and procedural protections, investors refrain from investing altogether, or increase investment costs (borne by states) to mitigate risks. Additionally, the critiques downplay the significance of a stable legal framework for existing investments. For prospective investments, the UN Report appears to absolve states from the responsibility of shaping their own ESG regulations and international obligations. Lastly, the UN Report neglects the notable rise in cases involving investments in the renewables sector, challenging that ISDS primarily serves as a mechanism favoring extractivism, benefiting fossil fuel, and extractive industries. This post will also show that ISDS can become an effective tool to ensure a sustainable future.

1. Unraveling Myth from Reality

The subsections below tackle common misconceptions, including some reflected in the UN Report, about the relationship between ISDS and ESG.

1.1 ISDS Does Not Thwart States' Regulatory Authority

The UN Report asserts that some states have refrained from taking bold climate action due to "perceived or actual threats of ISDS arbitration." (UN Report, ¶¶ 49-50)

At the outset, this argument fails to distinguish between existing and prospective investments.

As to existing investments, the idea that states should have unrestricted freedom to encourage, or at least welcome, foreign investment and then dismantle the legal framework governing those investments defies logic and justice. This is especially so, as states actively benefit from foreign investment through the injection of funds into their economies, job creation, and tax revenue. In this respect, by portraying that investors almost invariably take the lion's share while states get next to nothing, the UN Report misrepresents the transactional nature of foreign investment.

While recognizing the undeniable and desirable progress of ESG standards and the necessity for states and investors to adapt, regulatory changes must further legal certainty and uphold the rule of law to sustain international investment. Thus, that states must compromise with existing investors on measures adverse to their investments, if necessary, is not inherently nefarious. And if compromise is unattainable, international law protects states' regulatory powers in advancing the public interest. Even if certain investment tribunals may have failed to uphold those powers, as the UN Report suggests, the logical conclusion cannot be the demise of ISDS as a whole. Domestic courts may also misapply state laws at times, but it would be illogical to argue that such mistakes should lead to the elimination of domestic court systems.

Regarding prospective investments, states possess complete authority to establish domestic ESG regulations, making them as stringent as desired. Many treaties mandate that foreign investments be made in accordance with the host state's laws. If a host state has implemented ESG regulations, foreign investors must adhere to them, or their investments would not enjoy international protections. Even without this requirement, an investor would struggle to argue that the application of a regulation existing at the time of investment could violate the host state's international obligations. The challenge lies in the necessity for states to enact precise, enforceable regulations instead of leaving foreign investors responsible for upholding vague ESG principles. Enacting these regulations does not require approval from foreign investors.

The same holds true for IIAs, which are state-to-state endeavors. For example, an IBA Arbitration Committee report from October 2023 ("**IBA Report**"), highlights the bilateral investment treaty between Nigeria and Morrocco (signed, but not in force), which provides that foreign investors are to "maintain an environmental management system," "uphold human rights in the host state," "act in accordance with core labour standards," "[if] in areas of resource exploitation and high-risk industrial enterprises, [companies] shall maintain a current certification to ISO 14001 or an equivalent environmental management standard," and "not manage or operate the investments in a manner that circumvents international environmental, labour and human rights obligations to which the host state and/or home state are Parties." (IBA Report, p. 25) These obligations are framed in the Preamble in which the state parties recognized the contribution of foreign investment to their sustainable development, reaffirming their right to "regulate and introduce new measures relating to investments in their territories in order to meet national policy objectives and taking into account any asymmetries with respect to the measures in place, the particular need of developing countries to exercise this right." This treaty contains an ISDS clause providing for arbitration.

Here as well, the challenge is that states must agree on the ESG standards they want to apply. Once they do, investors must comply with them. Investors should not be penalized due to states' inability to reach such agreements.

Lastly, states can incorporate explicit provisions restricting investors from initiating arbitration claims if they have violated ESG principles. For instance, the IBA Report notes that the Morocco Model BIT prevents investors and investments from initiating dispute settlement under its provisions if they have not complied with anti-money laundering, bribery, corruption, and anti-terrorist standards outlined in Article 19 of the Model BIT (IBA Report, pp. 24-25). Investment tribunals have consistently adopted this approach, even without explicit provisions to that effect.

For example, in its recent award, the tribunal in *Worley Parsons v. Ecuador* observed that "the absence of an express legality clause in the Treaty does not preclude an enquiry into whether the Claimant's alleged investment complied with the law." (¶ 307) Rather, the tribunal added, the question is whether "a State would have given its consent to arbitration to protect investments that breached its own law." (¶ 304) The tribunal concluded that the "question must clearly be answered in the negative . . . ." (*Id*.) On that basis, the tribunal declined jurisdiction over the investor's claims, citing "a widespread pattern of illegality and bad faith" in the making of the investment. (¶ 419) The final award in *Álvarez y Marín Corporation and others v. Panama,* similarly stated that there is a legality requirement implicit in every investment treaty, such that it is "reasonable to assume that states have only consented to this curtailment of their sovereignty, under the condition that this protection mechanism is limited to investments made in accordance with their own legal systems." (¶ 135) Accordingly, a majority of the tribunal declined jurisdiction over the investors' claims due to a serious lack of compliance with Panamanian law. (¶ 398)

The UN Report's suggestion that ISDS primarily serves fossil fuel and extractive industries overlooks the sustained increase in the number of cases related to renewable energies, with at least 80 recorded as of September 2022. While many were brought under the Energy Charter Treaty and involved measures from a limited number of states, a clear conclusion emerges: ISDS is suitable for cases arising from the energy transition. As discussed above, however, states are responsible for establishing the substantive standards and reciprocal protections that will govern this transition.

1.2 ISDS Lacks a Clear Replacement

The UN Report recommends that states designate "domestic courts as the appropriate forum for resolving investor-State disputes and where necessary strengthening the independence, tenure and expertise of judges." (UN Report, ¶ 75) The proposal disregards realities such as inherent national biases in domestic courts and procedures that can routinely extend for as long as 10 years (especially in developing countries). It also imposes an oversized burden on national judiciaries, expecting judges to transition from resolving hundreds, if not thousands, of ordinary disputes to dealing with complex disputes involving multimillion-dollar investments and international law concepts alien to their core practice. In sum, the proposal is impractical, if not impossible, to implement, at least for most states, especially for developing ones.

Moreover, the United Nations Commission on International Trade Law (UNCITRAL) Working Group III is actively engaged in reforming the ISDS regime to address perceived shortcomings in areas like transparency and the balance between investor protection and the state's right to regulate for the public interest (*see*, *e.g.*, UNCITRAL Working Group III's work on the Draft provisions on procedural and cross-cutting issues, and previous coverage on the Blog here and here). Although the UN Report acknowledges this ongoing effort, it falls short in explaining why the changes being negotiated by states are deemed insufficient.

2. ISDS as a Tool for Sustainability

The IBA Report notes a proliferation of ESG-specific requirements in commercial contracts (refer to IBA Report § IV). These clauses, frequently incorporated as due diligence requirements or compliance obligations, seek not only to prevent harmful practices but also to improve stakeholder relationships and achieve regulatory compliance. A similar trend is observed in the context of ISDS.

As noted above, ESG language is becoming prevalent in modern IIAs. These clauses are not just symbolic; they are practical tools that guide investor behavior towards more sustainable and socially responsible practices. By embedding these principles in IIAs, States are creating a legal foundation that can balance investor rights with the urgent need for environmental protection and social equity.

The immediate task for states is clear: establishing ESG provisions that provide for clear and enforceable standards –domestic and international– to be observed by investors. Once that task is completed, international tribunals will be better positioned to resolve ESG-related investment disputes.

3. Conclusion

Faulting ISDS for states' failures to enact and enforce clear ESG standards is disingenuous. Also disingenuous is the assertion that states have fallen victim of a "regulatory chill" without distinguishing between existing and prospective foreign investments. Indeed, while states must not disregard existing investors' rights and should seek compromise, nothing prevents them from legislating for the future as they see fit.

Further, states have the ability to shape their international obligations and, consequently, foreign investors' rights through internal legislation. For example, internal laws and regulations are critical in determining investors' legitimate expectations. And, as numerous arbitral tribunals have observed, investors committing serious violations of their host states' laws may lose the right to resort to ISDS.

Foreign investment, particularly in developing countries, is urgently needed for a sustainable future. The availability of ISDS significantly influences investors' decisions. Abolishing it without presenting a viable alternative would thus be detrimental. Moreover, the abolitionist view clashes with positive developments such as the improvements advocated by UNCITRAL Working Group III and the inclusion of ESG-specific clauses in modern IIAs.

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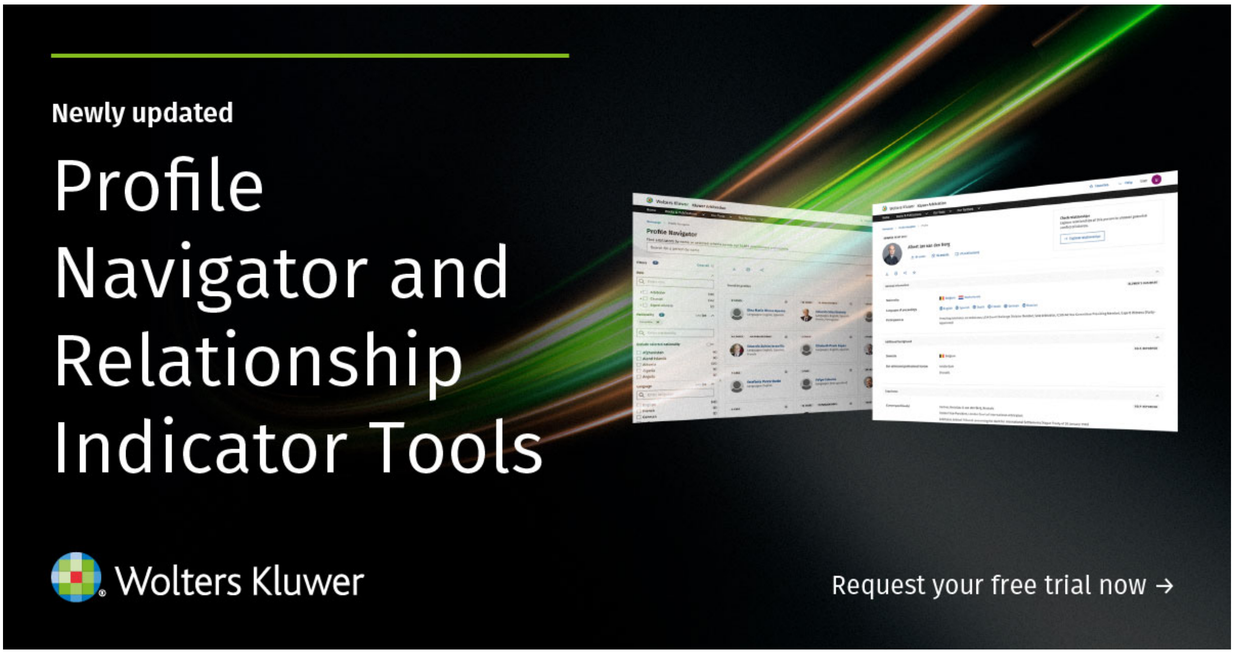

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