Introduction

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.

Over the last decade there has been an explosive increase of cases of investment arbitration. This is significant in terms of not only the *number* of disputes that have arisen and the number of states that have been involved, but also the novel *types* of dispute that have emerged. Rather than solely involving straightforward incidences of nationalization or breach of contract, modern 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.

How did such matters become the purview of unelected *ad hoc* panels whose expertise lies in the realm of commercial law? The answer is not immediately evident. It could be argued that it is states themselves that are responsible. Governments have quietly been negotiating bilateral and regional investment agreements which provide foreign investors with considerable legal protection and access to international arbitration. They have also been signing contracts directly with foreign investors that contain such privileges. However, while governments may have opened the door to investor-state dispute resolution, they arguably did not anticipate that arbitral tribunals would reach so far into the public policy domain. Investment agreements were created to promote foreign investment in developing countries and designed to protect investors from discrimination and particularly egregious conduct on the part of the host state. While the success that states have had in attracting foreign investment through investment agreements is a subject of heated debate, the success that investors have had in stretching the traditional meaning of clauses on 'expropriation' and 'fair and equitable treatment' is unquestionable.

Is the manifold increase in disputes and the extension of arbitration into the public policy sphere just another example of the changing nature of governance in the age of globalization? Does it matter? Should policy-makers and the public be concerned? This study aims to answer these questions by exploring the implications of investment agreements, foreign investment contracts and investment arbitration for one particularly topical area of public policy: the protection of the environment. Aside from the increasing public interest in environmental protection, the potential for foreign investment to have a substantial impact (whether positive or negative) on environmental conditions, particularly in developing countries, makes this an especially pertinent area for study.

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 between investors and the governments of Canada, Costa Rica, Mexico, Peru and the United States are discussed in this study. While the cases are, in many respects, illuminating, they raise more questions than they answer. This is, in part, because the decisions made by the arbitral tribunals in these cases are inconsistent. However, despite this, several trends in arbitral practice are identifiable. Significantly, it is clear that tribunals are not likely to accept a state's purported reason for adopting an environmental measure on its face, but will instead assess the measure's *legitimacy*. There is a certain degree of irony in this, given that many scholars have described the system of investment arbitration as being in the midst of its own 'legitimacy crisis'. Another critical development is the growing acceptance of *positive obligations*; states are required not only to refrain from taking certain actions, but must also comply with various tenets of 'good governance'. Again, it is worth noting that such principles (e.g., transparency, predictability) are not uniformly applied in investment arbitration itself.

Arbitrators have made it clear that they can, and will, award compensation to investors that claim to have been harmed by environmental regulation. But is this the whole story? Are the pleadings of the parties and the decisions of the tribunals in a few environmentally relevant cases all that need be assessed? One of the core claims of this book is that there is, in fact, much more to be told. It is contended that although many investor-state conflicts will not reach the stage of a formal dispute, they will nevertheless be resolved *in the shadow* of arbitration. Arbitration is expensive for both investors and states, but the *threat* of arbitration is cheap and potentially very effective. This study highlights several conflicts between investors and states concerning both environmental policy (in Ghana, Indonesia and Costa Rica) and domestic court proceedings related to corporate liability for environmental damage (in Indonesia and Ecuador), where an investor threatened to initiate arbitral proceedings. Some of the cases suggest that the mere threat of arbitration is sufficient to *chill* environmental policy development. Equally concerning, is the possibility that a government may use the threat of arbitration as an excuse or *cover* for its failure to improve environmental regulation.

Individually, the cases illustrate that the outcome of a conflict resolved in, or in the shadow of, arbitration may be positive or negative from an environmental policy perspective. States do not always capitulate to threats and investors do not always prevail in arbitration. However, taken together, the cases paint a bleak picture. It is evident that arbitrators have *expropriated* certain fundamental aspects of environmental governance from states. As a result, environmental regulation has become riskier, more expensive and less democratic, especially in developing countries.

What can governments do to reclaim their policy space? This book does not offer a 'silver bullet' solution, although several practical suggestions for moderate reform of investment agreements, foreign investment contracts and investment arbitration are presented. Ultimately, governments in developing countries need to be much more careful about the commitments that they make to other states and to foreign investors. For their part, governments in developed countries need to reassess their priorities; if they are serious about their commitments to 'sustainable development' they should devote resources to helping, not handicapping, developing countries in their efforts to regulate foreign investors.

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Kyla Tienhaara
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More information

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Concepts and methods

The existing literature on the relationship between investment protection and environmental protection is generally written either from the perspective of investment lawyers, who often neglect 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 provide 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.

In this chapter, the fundamental concepts of 'foreign direct investment', 'international investment agreements', 'foreign investment contracts', 'investor-state conflicts' and 'disputes', and 'environmental governance' are defined. The methodology employed in the empirical portion of the study is also explained. Finally, justification is provided for the especial attention that is given in this book to the interests and concerns of developing countries.

1.1 Foreign investment and the global economy

Foreign investment can be defined as: 'The transfer of tangible or intangible assets from one country into another for the purpose of their use in that country to generate wealth under the total or partial control of the owner of the assets.'[1] This definition encompasses both foreign direct investment (FDI), the transfer of physical property, and 'portfolio investment', the movement of money through the purchase of shares in foreign corporations.[2]

[1] Sornarajah 2004a: 7.
[2] *Ibid.* Portfolio investment composes an increasingly large share of global flows of investment, but this study focuses on FDI which has a greater potential to contribute to development and also presents clearer environmental implications. For a brief overview of some of the key environmental issues related to portfolio investments, see Araya 2005: 48.

While historically, developing countries have often exhibited animosity towards foreign investors, since the late 1980s there has been a discernible shift in most parts of the world toward openness to, and indeed active courting of, FDI. There is a belief among many developing countries that FDI can play an important role in the development process and can help to fill resource, technology and foreign exchange gaps.[3] FDI is currently the most important source of external finance in most developing countries because it is more stable than portfolio investment and bank lending, and far more available than official development assistance.[4]

FDI is also increasingly considered a key ingredient for achieving *sustainable development*; 'development which meets the needs of the present without compromising the ability of future generations to meet their own needs'.[5] At the World Summit on Sustainable Development (WSSD) held in Johannesburg in 2002, a great deal of emphasis was put on the importance of investment.[6] In the Political Declaration that emanated from that meeting was the remark that 'significant increases in investment flows around the world have opened new challenges and opportunities for the pursuit of sustainable development'.[7] The Summit's Plan of Implementation noted the need for 'an enabling environment for investment' which was viewed, as a part of good governance, as 'the basis for sustainable development'.[8] Finally, the Plan of Implementation also called for the creation of:

> *the necessary domestic and international conditions to facilitate significant increases in the flow of foreign direct investment to developing countries*, in particular the least developed countries, *which is critical to sustainable development*, particularly foreign direct investment flows for infrastructure development and other priority areas in developing countries to supplement the domestic resources mobilized by them.[9]

FDI flows have rapidly increased in recent history and, while downturns have periodically occurred, on average FDI flows have multiplied more rapidly than trade flows.[10] Global FDI reached a new record high in 2007 with inflows of US$1,833 billion.[11] While largely concentrated in

[3] Mosoti 2005: 95. [4] Morgera 2004: 215.
[5] World Commission on Environment and Development 1987: 43.
[6] Report of the World Summit on Sustainable Development (WSSD), Johannesburg, South Africa, 26 August–4 September 2002, UN Doc. A/CONF.199/20, www.un.org/esa/sustdev.
[7] Political Declaration (in Report of the WSSD): para. 14.
[8] Plan of Implementation (in Report of the WSSD): para. 4.
[9] *Ibid*: para. 84(a), emphasis added. [10] Cohn 2004: 313. [11] UNCTAD 2008: 3.

the ‘triad’ of Western Europe, North America and Japan, the share of FDI flows directed to developing countries has increased in the last decade. However, this fact masks the reality that only a small group of developing countries – particularly China, Mexico, Singapore, Malaysia and Brazil – are really benefiting from these increased flows while other countries, especially those in sub-Saharan Africa, are increasingly marginalized.[12]

1.1.1 Competition for foreign investment

As there is not an unlimited supply of foreign investment that is equally distributed around the world, it is often argued that states must compete for FDI.[13] This notion of state competition for FDI has ‘become deeply entrenched in the conventional policy rhetoric’.[14]

Governments compete for investment by providing incentives (such as tax holidays, loan guarantees and cash grants) and also by differentiating their legal jurisdictions from those of their competitors.[15] In this latter sense, legal reform has become an important asset for developing countries in their bid to attract FDI.[16] According to the 2005 World Investment Report, 2,156 measures related to foreign investment were adopted by 102 developing countries between 1991 and 2004, the vast majority of which (93 per cent) were aimed at creating a more favourable environment for investors.[17] Similarly, around 120 countries reformed their mineral regimes between 1985 and 2002.[18] These mineral reforms have generally aimed at liberalization as well as at establishing an investment climate based on stability and predictability.[19]

As Van Harten points out, when states compete for investment ‘the bar rises as to what qualifies as a hospitable investment climate’.[20] Guzman describes this as a ‘bidding up’ of concessions to foreign investors.[21]

1.1.2 Protecting foreign investors

Developing countries can make numerous unilateral efforts to advertise themselves as desirable hosts for FDI, but such measures will be limited by the ‘credible commitment’ problem. That is to say, governments cannot signal to investors in a meaningful way that national laws providing them

[12] Cohn 2004: 325. [13] Oman 2000: 15–16.
[14] Kozul-Wright and Rayment 2007: 160. [15] Encarnation and Wells 1985: 48.
[16] Trubek *et al.* 1994: 477. [17] UNCTAD 2005c: 26. [18] Otto and Cordes 2002: III–3.
[19] Bastida 2002. [20] Van Harten 2007a: 43. [21] Guzman 1998: 671–2.

with protection will not simply be reversed once they have established themselves in the country. Consequently, even when developing countries make fervent overtures to the investment community, perceived political risk may continue to hinder FDI flows.

The purported solution to this problem has been the creation of agreements that govern the relationship between investors and governments and shift dispute resolution out of local courts and into international arbitration. Traditionally, investment was mainly protected through investor-state agreements, variously referred to in the literature as 'host government agreements', 'economic development agreements' or 'state contracts', and described herein as 'foreign investment contracts'. Foreign investment contracts are still used extensively in developing countries, especially in the natural resource sectors, and are given particular attention in this study. However, in addition to these contracts which cover only specific investments, protection can also be more generally provided through intergovernmental agreements.

In 1995, negotiations on one such intergovernmental agreement, the Multilateral Agreement on Investment (MAI), were commenced under the auspices of the Organisation for Economic Cooperation and Development (OECD). While the OECD is not a global forum, the MAI, once completed, would have been opened up for signature by any country. However, the negotiations were plagued by disagreements among OECD members as well as ardent opposition from civil society. In 1998 the MAI talks fell apart and the anti-globalization movement claimed this as its first major victory.[22] However, in 2003, the issue of a multilateral agreement on investment protection again came to the fore at the World Trade Organization (WTO) Ministerial Conference in Cancún. These talks were also a dramatic failure and, as a result, there is currently no prospect for a global treaty on investment (see further Section 3.1.3.2).

The main concern expressed by non-governmental organizations (NGOs) about the MAI and WTO negotiations on investment was that foreign investors would be given the right to sue states when public policy measures negatively affected their investments. However, little notice has been taken (by the media, the public, or most NGOs) of the fact that over the last two decades governments have quietly committed to equivalent levels of investment protection, including investor access to international

[22] Klein 2000: 443.

arbitration, in a massive number of regional, sectoral and bilateral agreements.[23] As of the end of 2008, there were 2,676 bilateral investment treaties (BITs) and 273 free trade agreements (FTAs) and economic cooperation agreements containing investment provisions.[24] These agreements are collectively referred to in this book as international investment agreements (IIAs).

Only one IIA, the North American Free Trade Agreement (NAFTA), which has a chapter on investment protection (see Section 3.1.3.1), has received significant scrutiny from scholars, although it remains poorly understood by the public. While NAFTA's Chapter 11 has been a focal point of debate, particularly in the wake of several controversial investor-state disputes, it is only one agreement among many. In fact, as a result of the proliferation of IIAs and the chameleon-like ability of transnational corporations (TNCs)[25] to change their nationality, investments all over the world receive legal protection similar to that provided by Chapter 11.

1.2 Conflicts between foreign investors and host states

There is an extensive literature on the impact of FDI on the environment, and this is briefly reviewed in Chapter 2. However, this book is primarily about the impact of foreign investors and the agreements that protect them on *environmental governance* in the host state.

Environmental governance can be defined as 'the resolution of environmental conflicts through the establishment, reaffirmation or change of institutional arrangements, which may either facilitate or limit the use of environmental resources'.[26] Significant developments in *global* environmental governance have occurred in recent years, but binding rules on

[23] Regional investment agreements cover many sectors and involve more than two states bound within a geographic area. Sectoral agreements cover only one sector of investment (e.g., energy) but involve more than two states. It should be noted that the Energy Charter Treaty, which contains a chapter on investment, is a significant sectoral investment agreement, but it is not addressed further in this study. For a discussion of the Energy Charter Treaty with specific reference to the relationship between investment protection and environmental protection see Wälde 1998b; Chalker 2006. Finally, bilateral agreements involve only two states. Investment agreements may be stand-alone agreements or only one part of a larger agreement which covers several issues (e.g., trade, economic cooperation).

[24] UNCTAD 2009b: 2, 8.

[25] Brewer and Young 1998: 11, define a TNC as 'an enterprise which owns (in whole or in part), controls, and manages value-adding activities in more than one country'. TNCs are also commonly referred to as multinational corporations or multinational enterprises.

[26] Adger *et al.*, qtd in Paterson *et al.* 2003: 3.

corporate conduct have not yet emerged (see Section 2.3.2). Host states, with varying capacities in monitoring and enforcement, are therefore responsible for regulating foreign investment to ensure that sustainable development goals are met and the environment is protected. However, when domestic regulation negatively impacts an investment, conflicts between a foreign investor and the host state may emerge.

Increasingly, domestic environmental policies and opposition to investment projects from communities and NGOs are seen as major risks for foreign investors.[27] For example, the imposition of a new environmental policy can be costly, and may be particularly onerous if it was not anticipated by the investor and therefore was not taken into account in the cost-profit analysis that informed the decision to invest in the first place.[28] In such a situation, there are three possible strategies for an investor to pursue: to accept the environmental policy and associated costs; to relocate to another jurisdiction; or to contest the policy through lobbying, litigation, etc.[29]

An investor may accept the new regulation for a variety of reasons: it may not significantly interfere with his investment; he may be concerned with damaging his relationship with the government by 'kicking up a fuss'; he may be aiming to improve his image as an environmental leader in the industry; or he may fear reprisals from domestic or international NGOs if he does not accept the policy. In any event, the investor's decision to *not act* presumably has no negative implications for environmental governance. However, the issue is far more complicated in cases where an investor *does act*.

In studies of the relationship between foreign investment and the environment, considerable focus has been given to the fact that '*states have roots while investors have wings*'.[30] While this is certainly an important observation, it is nevertheless the case that when investors have a choice between *fight* or *flight*, they often opt for the former. This is particularly the case in capital-intensive investments with large sunk costs, such as mining and oil operations.[31] Furthermore, investors may have several projects in a country (and only be in conflict in respect of one) or may have an interest in future investment opportunities which would be ruled out by a strategy of exit.

Investors faced with a conflict with the host state may, therefore, choose instead: to lobby or negotiate directly with the host government; to

[27] Wälde 1998b: 245; Bastida 2001: 42. [28] Bekhechi 2001: 86. [29] Murphy 2004: 87.
[30] Beck 2005: 72. [31] Murphy 2004: 88; Newcombe 2007b: 439–40.

delegate resolution of the conflict to a third party; to utilize reputation and shame sanctions;[32] to enlist the assistance of its home state; and/or to *threaten* to exit or to utilize one or more of the measures listed above.

Within the category of delegation to a third party, the investor may have several choices. Depending on the circumstances, an investor could litigate (i.e., pursue a case in the local courts of the host state or in foreign courts), utilize conciliation or mediation mechanisms, or arbitrate (in international investment arbitration). It is the use of, or the threat to use, international investment arbitration to resolve investor-state conflicts that is the focus of this book.

1.2.1 Case studies of investor-state conflict

The empirical part of this study (Chapters 7 and 8) is concerned with the role that international arbitration plays in the outcome of conflicts between investors and states that are related to the environment. This issue is addressed through a number of case studies. The aim of the case studies is to assess how a conflict is interpreted by members of the community (investors, states, tribunal members, NGOs) as well as the communicative action that the conflict gives rise to, such as reproaches, excuses, justifications, etc.[33]

Identifying when a conflict between an investor and a state is related to the environment is a complicated matter. If one were to define conflict at a normative level, one would require precise definitions of the norms relevant to investment protection and to environmental protection in order to identify when these norms are in conflict. However, the norms of both investment protection and of environmental protection are notoriously vague and require case-by-case interpretation (see Chapter 4). As such, defining a conflict as environmentally relevant on a normative basis is problematic.

To simplify matters, in this study a conflict between an investor and a state is considered relevant when one or both of the actors subject to the conflict *individually or collectively identifies it as relating to both an environmental issue and to a foreign investment contract or an IIA*. To be clear, this definition does not require that both parties *agree* that the conflict is related to an environmental issue or to a foreign investment contract/IIA. For instance a government could argue that a measure was introduced

[32] Ginsberg 2005: 107.
[33] Kratochwil and Ruggie 1986: 768; Hasenclever *et al.* 1997: 16.