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THE FAIR AND EQUITABLE TREATMENT STANDARD: LEGITIMATE EXPECTATIONS ON STABILITY FACING REGULATORY CHANGES

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Abstract

This article examines the possibility of invoking the protection of legitimate expectations under the fair and equitable treatment standard to strike down questionable regulatory changes taken by a host State in investor-State investment arbitrations. Drawing from jurisprudence of investment arbitral tribunals, it also lays out two tests that regulatory changes have to withstand in order to be

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legitimate under the fair and equitable treatment. Finally, it engages in preliminary investigations into the general justifications available for host States to justify the regulatory changes, in case these measures are potentially or established as violations to the fair and equitable treatment.

Key Words: Investment Arbitrations; the Fair and Equitable Treatment Standard; Regulatory Changes; Stability; Proportionality; Necessity.

El Estandar Del Trato Justo Y Equitativo: Expectativas Legítimas Sobre La Estabilidad Al Enfrentar Cambios Regulatorios

Resumen

Este artículo evalúa la posibilidad de una protección jurídica sobre las expectativas legítimas de un inversor bajo el Estandar del Trato Justo y Equitativo con el fin de derogar los cambios regulatorios de un Estado anfitrión en cuanto a las inversiones hechas en su territorio. Examinando la jurisprudencia de los tribunales arbitrales, se podrá analizar y poner en evidencia dos tests que demuestren cómo esos cambios regulatorios tendrían que ser conforme al Trato Justo y Equitativo. En último lugar, sería necesario hacer un análisis sobre las razones que justifican la adopción por un Estado Anfitrión de aquellos cambios regulatorios, con el fin de poder identificar cuáles serían los que potencialmente han sido establecidos sin cumplir el Trato Justo y Equitativo.

Palabras clave: Arbitraje de inversiones; Estandar del Trato Justo y Equitativo; Cambios regulatorios; Estabilidad; Proporcionalidad; Necesidad.

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1. INTRODUCTION

The Fair and Equitable Treatment (“FET”) standard² has grown into a prominent standard generally found in modern Bilateral Investment Treaties (“BITs”)³

² The FET Standard is an investment protection standard contained in international investment treaties that aims for reciprocal protection of foreign investments between and among contracting States. The investment treaties usually provide an arbitration mechanism, known as treaty-based investment arbitration mechanism, for the resolution of disputes concerning alleged violations of the FET and other standards.

³ See, e.g., Agreement between the People’s Republic of China and the Federal Republic of Germany on the Encouragement and Reciprocal Protection of Investments [hereinafter China-

and many multilateral investment treaties (“MITs”)⁴ for the investment protection of foreign investors.⁵ While precise definitions are usually absent in these treaties and waited to be further clarified,⁶ the FET standard has been described in case law as being associated with elements such as, among others, good faith, transparency and due process, and interpreted as imposing obligations on host States to act in a consistent, non-arbitrary and even-handed manner.⁷ It is also known as an “objective” and “absolute” standard, not requiring the bad faith on the part of host States or being treated less favorably than national investors to establish a breach.⁸ This indeterminacy of the exact scope of the FET standard,

Germany BIT], adopted 1 December 2003, entered into force 11 November 2005, 2362 U.N.T.S. 25, Article 3(1).

⁴ See, e.g., North American Free Trade Agreement [hereinafter NAFTA], adopted 17 December 1992, entered into force 1 January 1994, 32 I.L.M. 289 (1993), Article 1105(1); Energy Charter Treaty [hereinafter ECT], adopted 17 December 1994, entered into force 16 April 1998, 2080 U.N.T.S. 95, 34 I.L.M. 360 (1995), Article 10(1).

⁵ In treaty-based investment arbitrations, the scope of “foreign investors” and “investment” depends on how the relevant investment treaty at issue defines it. Generally speaking, “foreign investors” may be natural persons or juridical persons who attempt to make, are making, or have made an investment in the territory other than their home States. “Foreign investors” are allowed to use the investor-State dispute settlement mechanism to protect their legitimate rights regarding their investments. “Investment” may have a broad definition covering movable and immovable property, shares and other claims in an enterprise, intellectual property rights, licenses and business concessions, etc. See e.g., 2012 U.S. Model Bilateral Investment Treaty, [hereinafter U.S. Model BIT], available at <http://www.ustr.gov/sites/default/files/BIT%20text%20for%20ACIEP%20Meeting.pdf> (last visited, 31 July 2014) UNCTAD, “Investor-State Disputes arising from Investment Treaties: A Review”, UNCTAD/ITE/IIT/2005/4, 2005, pp. 15-16.

⁶ See e.g., *CMS Gas Transmission Company v. The Argentine Republic*, ICSID Case No. ARB/01/8, Award, 12 May 2005, [hereinafter *CMS Award*], para. 273; *Alex Genin, Eastern Credit Limited, Inc. and A.S. Baltoil v. The Republic of Estonia*, ICSID Case No. ARB/99/2, Award, 4 April 2002 [hereinafter *Genin*], para. 367; See also, UNCTAD, “Fair and Equitable Treatment”, IIA Issues Paper Series, UNCTAD/ITE/IIT/11, (Vol. 3, 1999), p. 10 et seq; Brownlie, I., *Principles of Public International Law*, 5th ed., Oxford and New York, Clarendon Press, 1998, p. 529.

⁷ See e.g., *Swisslion DOO Skopje v. The former Yugoslav Republic of Macedonia*, ICSID Case No. ARB/09/16, Award, 6 July 2012, para. 273; *Rumeli Telekom AS and Telsim Mobil Telekomikasyon Hizmetleri A.S v. Republic of Kazakhstan*, ICSID Case No. ARB/05/16, Award, 29 July 2008, para. 609; *Biwater Gauff (Tanzania) Ltd v. United Republic of Tanzania*, ICSID Case No. ARB/05/22, Award, 24 July 2008, [hereinafter *Biwater*], para. 602. It should be noted that the indeterminacy of the FET standard leads to the importance of treaty interpretation. In arbitral practice, the FET standard may be interpreted as an expression of the minimum standard of treatment under customary international law, especially when it comes to NAFTA, the text of which explicitly referred to international law, otherwise it is more likely to be considered as an autonomous self-contained standard. See e.g., *National Grid P. L.C. v. Argentine Republic*, UNCITRAL, Award, 3 November 2008, [hereinafter *National Grid*], para. 167; *Suez, Sociedad General de Aguas de Barcelona, Vivendi SA and Universal, S.A. v. Argentine Republic*, ICSID Case No. ARB/03/19, Award, 30 July 2010, [hereinafter *Suez*], para. 214; Yannaca-Small, C., “Fair and Equitable Treatment Standard in International Investment Law”, OECD Working Papers on International Investment, (No. 2004/3, September 2004), p. 1; Schreuer, C., “Fair and Equitable Treatment in Arbitral Practice”, *J.W.I.T.*, (Vol. 6, No.3, June 2005), pp. 359-367.

⁸ See, e.g., See e.g. *Jan Oostergetel or Laurentius and Theodora v. The Slovak Republic*, UNCITRAL, Final Award, 23 April 2012, para. 227; *Compania de Aguas del Aconquija S.A. and Vivendi Universal S.A.*

combined with its general and non-contingent nature, makes the FET standard frequently invoked and buttressed in investor-State investment arbitration cases, as if it is a gap-filler tool in favor of foreign investors' interests.⁹

Such is the case when disputes arise concerning the legitimacy of a host State to introduce regulatory changes in an economic sector after investments have been made by foreign investors therein. Those regulatory changes might have not amounted to the expropriation of the investment, even in the sense of indirect expropriation, but can still considerably impair the value and/or return of said investments. While it is less controversial that arbitrary or discriminatory regulatory changes taken seldom meet the FET standard,¹⁰ the issue becomes more complicated when regulatory changes are genuinely (or at least they appear to be) based on concerns of public interests, such as environmental and health concerns, and apply to domestic and foreign investors alike.

For one thing, international law generally recognizes the regulatory power of host States,¹¹ the proper exercise of which "may cause economic damage to those subject to its powers as administrator without entitling them to any compensation."¹² For another thing, the FET standard, general as it is, is not of no limit. For example, the *El Paso* Tribunal has qualified the invocation of the FET standard to situations "where there is an unreasonable interference bringing about an unjust result regarding an investor's expectation."¹³ Likewise, the *Continental Casualty v. Argentina* Tribunal describes the FET standard as safeguarding the normal business activities "not hampered without good reasons by the host government and other authorities."¹⁴

In closer examination of the FET standard, it's not difficult to identify one element particularly vulnerable in collision with general regulatory changes. That is

v. Argentina, ICSID Case No. ARB/97/3, Award, August 20, 2007, para. 7.4.12; Yannaca-Small, C., *ibid*, p. 1.

⁹ *PSEG Global Inc. and Konya Ilgin Elektrik Üretim ve Tikaret Limited Sirketi v. Republic of Turkey*, ICSID Case No. ARB/02/5, Award, 19 January 2007, [hereafter *PSEG*], para. 239; Schill, S. W., "Fair and Equitable Treatment under Investment Treaties as an Embodiment of the Rule of Law", *IIJ Working Paper*, (No. 6, 2006), p. 5.

¹⁰ See, e.g., *El Paso International Company v. The Argentine Republic*, ICSID Case No. ARB/03/15, Award, 31 October 2011, [hereinafter *El Paso*], para. 230.

¹¹ See e.g., *Methanex Corporation v. United States of America*, UNCITRAL, Final Award, 3 August 2005, 44 I.L.M. 1343, [hereinafter *Methanex*], Part IV, Chapter D, para. 7; Vaughan Lowe, "Regulation or Expropriation", *Current Legal Problems* 447, Vol.55, Issue 1, 2002, p. 460.

¹² *Técnicas Medioambientales Tecmed S.A. v. The United Mexican States*, ICSID Case No. ARB (AF)/00/2, Award, 29 May 2003, [hereinafter *Tecmed*], para. 119.

¹³ *El Paso*, *supra* n9, para. 230.

¹⁴ *Continental Casualty Company v. The Argentine Republic*, ICSID Case No. ARB/03/9, Award, 5 September 2008, [hereinafter *Continental*], para. 254.

the requirement of stability in the States' behaviors: either stability by itself,¹⁵ or stability arising out of investors' legitimate expectations on stability of the legal framework.¹⁶ This article, in light of its limited length, will focus the research on the latter point, namely, to draw jurisprudence from arbitral tribunals and examine whether foreign investors' legitimate expectations on stability can help defend against host States' general regulatory changes, especially those truly motivated by public interests.

Therefore, this article would first look into the concept of **foreign investors' legitimate expectations** under the FET standard in **Section 2**, reviewing how an expectation on stability can be termed as "legitimate", as a basis for analyzing its interaction with regulatory changes. Next, **Section 3** will shed lights on the side of **regulatory changes**, examining what requirements a regulatory change needs to conform with in order to be justified as an appropriate and legitimate exercise of host States' sovereign powers. Drawing from arbitral tribunals' practice, two tests will be set out for this examination. **Section 4** will engage in a preliminary discussion, to explore the possibility if a **State can nonetheless exclude its liability**, even though it fails to respect the legitimate expectations of investors and nor has it complied with the tests set out in Section III. Finally, the article will close with a **Conclusion Section** and a **Flow Chart** illustrating the **reasoning process** when encountering the conflicts between investors' legitimate expectations under the FET standard and host States' regulatory powers.

2. LEGITIMATE EXPECTATIONS ON STABILITY

The protection of investors' legitimate expectations has been repeatedly identified by arbitral tribunals as an integral part of the FET standard.¹⁷ Its status was even elevated to "a dominant element of the FET standard" by some recent arbitral practice¹⁸ and recognized as "one of the two pillars" of foreign investment

¹⁵ See, e.g., *LG&E Energy Corporation v. Argentine Republic*, ICSID Case No. ARB/02/1, Decision on Liability, 3 October 2006, [hereinafter *LG&E*], para. 125, recognizing stability of the legal framework "to be an emerging standard of fair and equitable treatment in international law"; *Plama Consortium Limited v. Republic of Bulgaria*, ICSID Case No. ARB/03/24, Award, 27 August 2008, [hereafter *Plama*], para. 177; *Ioan Micula, Viorel Micula, S.C. European Food S.A., S.C. Starmill S.R.L and S.C. Multipack S.R.L v. Romania*, ICSID Case No. ARB/05/20, Award, 11 December 2013, [hereinafter *Micula*], para. 528.

¹⁶ See, e.g., *LG&E*, *ibid.*, para. 127; *Micula*, *ibid.*, para. 519.

¹⁷ See, e.g., *National Grid*, *supra* n6, para. 173; *Thunderbird Gaming Corporation v. The United Mexican States*, UNCITRAL, Separate Opinion by Thomas Wälde, 26 January 2006, [hereinafter *Thunderbird Separate Opinion*], para. 37.

¹⁸ *Saluka Investments BV (The Netherlands) v. The Czech Republic*, UNCITRAL, Partial Award, 17 May 2006, [hereinafter *Saluka*], para. 302.

law.¹⁹ In their views, the FET standard imposes the obligation on host States to provide international investments with the treatment that does not affect “the basic expectations that were taken into account by the foreign investor to make the investment.”²⁰ Thus that “the evisceration of the arrangements in reliance upon [which] the foreign investor was induced to invest” led the arbitral tribunals to hold the host State liable in breach of the FET standard.²¹

In light of this, can investors legitimately expect a stable business environment and legal framework, therefore protecting themselves against subsequent unfavorable regulatory changes? Although some tribunals have adopted an expansive view on legitimate expectations that seem to give an answer “yes”,²² a thorough review from arbitral jurisprudence indicates that investors’ legitimate expectations have to be justified with specific circumstances of the case at issue.²³ In general, investors’ legitimate expectations would have to be assessed objectively and balanced with the regulatory powers of host States. Specific commitments promising stability of the legal framework can make a distinction in inducing legitimate expectations for stability, but due attention is necessary to distinguish their nature and contents.²⁴

2.1. Objective examination

First of all, international law does not protect solely “subjective expectations of the investor” to secure the value of their investment.²⁵ Rather, only those expectations genuinely and reasonably arising out of general or specific circumstances of the host State at the time of making the investment,²⁶ and

¹⁹ Dolzer, R., “Fair and Equitable Treatment: A Key standard in Investment Treaties”, *The International Lawyer*, (Vol.39, No. 1, 2005), p. 105.

²⁰ *Tecmed*, *supra* n11, para. 154.

²¹ *CME Czech Republic B.V. (The Netherlands) v. The Czech Republic*, UNCITRAL, Partial Award, 13 September 2001, para. 611.

²² *Tecmed*, *supra* n11, para. 154.

²³ See e.g., *National Grid*, *supra* n6, para. 175.

²⁴ See generally, UNCTAD, “Fair and Equitable Treatment, A sequel”, *UNCTAD Series on Issues in International Investment Agreements II*, UNCTAD/DIAE/IA/2011/5, (February 2012).

²⁵ *El Paso*, *supra* n9, para. 358; *EDF (Services) Limited v. Romania*, ICSID Case No. ARB/05/13, Award, 8 October 2009, para. 219.

²⁶ See, e.g., *Plama*, *supra* n14, para. 267, the Claimant accused Bulgaria of breaching the FET standard for the delaying tax law reform, which resulted in untrue tax liability and pushed the investor’s refinery into bankruptcy. While confirming ECT Article 21 excludes taxation measures from treaty protection, the Tribunal nonetheless made a comment on this claim. The Tribunal noted that the relevant tax law was what was in force when the Claimant made its investment, and the Respondent had never promised to reform. Thus, the expectation that “it would be treated otherwise” was considered not legitimate. See also, *Alpha Projektholding GmbH v. Ukraine*, ICSID Case No. ARB/07/16, Award, 8 November 2010, para. 421.

reasonably relied upon by investors when making the investment,²⁷ merit the protection.²⁸

Arbitral practice has indicated that all circumstances surrounding the making of the investment, including but not limited to the legal framework, business environment, political, socioeconomic and cultural conditions, would have to be taken into account to verify the legitimacy and reasonableness of the expectations of investors.²⁹

Taking subsequent regulatory changes into consideration, if the investment was made in a transitional economy, and its legal system was undergoing and could be foreseeable to continue with frequent reforms and changes, in the absence of the host State's specific commitments to stabilize relevant laws that the investor did rely upon, it is hard to support that the investors could legitimately expect the laws surrounding their investments would be unchanged. The *Parkerings-Compagniet v. Lithuania* case was a good illustration. Given the fact that the Claimant had invested in 1998, a time when Lithuania was preparing its accession to the European Union ("EU"), the Tribunal concluded a reasonable businessman would have been aware of the risk that subsequent unfavorable legislative changes might take place and affect his investment.³⁰

Similarly, if an investment was made in an economy where concerns for certain public interests are popular, with the call for associated regulatory changes roaring, the investor cannot pretend to have legitimate expectations on regulatory stability. This was the case in *Methanex v. USA* with regard to a chemical named MTBE used in the production of gasoline for its potential health and environmental risks, and the Tribunal denied Methanex's expectation on regulatory stability accordingly.³¹

2.2. Balancing with regulatory power

Indeed, investors can always expect "the observation by the host State of such well-established fundamental standards as good faith, due process, and non-

²⁷ See, e.g., *Continental*, *supra* n13, paras. 259-260, emphasizing that the general legislative "assurances" for legal stability was not relied by the Claimant in making the investment, as the Claimant entered into the market before such "assurances" were given. See also, *National Grid*, *supra* n6, para. 175.

²⁸ Kriebaum, U. and Schreuer, C., "At What Time Must Legitimate Expectations Exist?", *TDM*, (Vol.9, No.1, January 2012), p. 265.

²⁹ *Saluka*, *supra* n17, para. 301. *Duke Energy Electroquil Partners & Electroquil S.A. v. Republic of Ecuador*, ICSID Case No. ARB/04/19, Award, 18 August 2008, para. 340; *Micula*, *supra* n14, para. 670.

³⁰ *Parkerings-Compagniet AS v. Republic of Lithuania*, ICSID Case No. ARB/05/8, Award, 11 September 2007, [hereinafter *Parkerings*], para. 335.

³¹ *Methanex*, *supra* n10, Part IV, Chapter D, paras. 9-10.

discrimination.”³² Specific commitments given by host States to individual investors are not a must in inducing legitimate expectations. However, legitimate expectations for stability arising solely from the general legal framework are considerably weak, as international law well respects the regulatory flexibility of host States to pursue public interests and adapt themselves to new circumstances.³³

As mentioned, international law acknowledges that the correct exercising of host States’ sovereign rights, often referred to as “regulatory power” or “police power”, is not considered as a breach of the FET standard,³⁴ nor would it constitute a measure tantamount to expropriation.³⁵ Needless to say, a State would be liable for abusing its regulatory and acting unfairly, unreasonably or inequitably.³⁶ Yet, the notion of regulatory power makes it clear to investors that they could and should be aware of the possibility of regulatory changes from host States to implement policies *bona fide* and justified by public purposes and objectives.

Therefore, it is beyond reasonableness to assume that a State, by passing a legislation or entering into a BIT, would make a general commitment to all foreign investors on abandoning its regulatory power under its national laws or policies, freezing the laws and promising never to change its legislation whatever the circumstances may be.³⁷ Moreover, treaty preambles or articles containing wordings like “to create stable, equitable, favorable conditions for investments/investors”, alone, could not be interpreted so broadly as a freezing clause. ECT cases *Plama v. Bulgaria* and *AES Summit v. Hungary* have set up correct precedents in this regard.³⁸

This deference to regulatory power is worthy of emphasizing so as to avoid an over-expansive interpretation of the FET standard. The good wish highlighted in the *Tecmed* award, which requires host States to uphold investors’ legitimate

³² *Sahuka*, *supra* n17, para. 303; *Electrabel S.A. v. The Republic of Hungary*, ICSID Case No. ARB/07/19, Decision on Jurisdiction, Applicable Law and Liability, 30 November 2012, [hereafter *Electrabel*], para. 7.78.

³³ See, e.g., *Electrabel*, *ibid*, para. 7.77; *Marvin Roy Feldman Karpa v. United Mexican States*, ICSID Case No. ARB(AF)/99/1, Award of 16 December 2002, para. 103.

³⁴ *Genin*, *supra* n5, paras. 348-373.

³⁵ *Methanex*, *supra* n10, Part IV, Chapter D, para. 7.

³⁶ See, for example, *S.D. Myers v. Canada*, UNCITRAL, Partial Award, 13 November 2000, in this case the Claimant successfully established the host State was in breach of FET for introducing an export ban on polychlorinated biphehyl waste in a discriminatory and unfair manner with no legitimate environmental reasons.

³⁷ *MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile*, ICSID Case No. ARB/01/7, Award, 25 May 2004, para. 99; *El Paso*, *supra* n9, para. 372; *Total S.A. v. Argentina*, ICSID Case No. ARB/04/01, Decision on Liability, 21 December 2010, [hereafter *Total*], para. 117.

³⁸ *Plama*, *supra* n14, para. 219; *AES Summit Generation Limited and AES-Tisza Erőmű Kft v. The Republic of Hungary*, ICSID Case No. ARB/07/22, Award, 23 September 2010, [hereafter *AES Summit Award*], para. 9.3.29.

expectations and imposes a general and one-sided obligation on the host State to act in a consistent, unambiguous and totally transparent manner,³⁹ “is rather a description of perfect public regulation in a perfect world, to which all States should aspire but very few (if any) will ever attain.”⁴⁰ Far from such a high standard, the objective assessment and the balance with regulatory power considerably qualifies the legitimate expectations to the extent that, in absence of specific commitments to the contrary, legitimate expectations deriving from the general legal framework “may only have a more marginal scope of application”⁴¹ to strike down unreasonable regulatory changes without proper justifications.⁴² As for the question on what regulatory changes may be “reasonable” under the FET standard, discussions will follow in Section III below.

2.3. Specific commitments

Even though general legitimate expectations seem to be weak vis-à-vis host States’ regulatory power, the evaluation on legitimate expectations appears to be a different story with the host State’s specific commitments inducing the investment. When such commitments relate to stabilize certain laws and regulations, then investors’ corresponding expectation for stability is “undoubtedly ‘legitimate’” and the host State is bound to guarantee foreign investors such promised stability.⁴³ In those situations, host States’ legitimate regulatory power would be restricted, as host States have voluntarily foregone part of the power to the extent of the commitments given.

The significant role that specific commitments play in generating strong legitimate expectations⁴⁴ draws us to have a closer look at what constitute “specific commitments”. According to the *Parkerings* Tribunal, specific commitments could be “explicit promise or guaranty” received from the host State, or “if implicitly, the host-State made assurances or representation that the investor took

³⁹ *Tecmed*, *supra* n11, para. 154.

⁴⁰ Douglas, Z., “Nothing If Not Critical for Investment Treaty Arbitration: *Occidental, Eureko and Methanex*”, *Journal of Arbitration International*, Kluwer Law International 2006, (Vol. 22, No. 1, 2006), p. 27.

⁴¹ Schill, S. W., *supra* n8, p28.

⁴² *El Paso*, *supra* n9, para. 372; *Saluka*, *supra* n17, para. 307; *Micula*, *supra* n14, para. 673; *Parkerings*, *supra* n29, para. 332; *Electrabel*, *supra* n31, para. 7.77.

⁴³ See, *Total*, *supra* n36, para. 117.

⁴⁴ For example, *Eureko B.V. v. Republic of Poland*, UNCITRAL, Partial Award, 19 August 2005, [hereinafter *Eureko*], paras. 232-234. *Eureko* purchased 30% shares of a Polish state-owned insurance company from the State Treasury of Poland, with the belief that a subsequent Initial Public Offering (“IPO”) would enable it to gain a controlling stake of the company, as envisaged in the Share Purchase Agreement. The subsequent failure of Poland due to political reasons to implement the IPO was considered as a frustration of *Eureko*’s legitimate expectations and termed by Tribunal as outrageous and shocking.

into account in making the investment.”⁴⁵ Reasoned by *El Paso Tribunal*, a commitment can be considered “specific” in two ways: it may be addressee-specific, concerning commitments made “directly to the investor”, taking the form of a contract, a letter of intent, or even a specific promise in a person-to-person business meeting; or it may be objective-specific: a State acting in a manner with the goal “to give investor real guarantee of stability.”⁴⁶

Needless to say, a most apparent example of specific commitments would be a stabilization clause contained in an investment contract signed with a host State. Such a stabilization clause fulfills the two scenarios mentioned by the *El Paso Tribunal* in the meantime, and therefore strengthens investor’s legitimate expectation to the extent of requiring no modification of the laws and regulations falling within its coverage.⁴⁷ If the host State behaves otherwise, it has to compensate the losses and damages incurred to the investor or its investment.

Of course, a stabilization clause is not the only manifestation of specific commitments. In fact, it is not easy for investors to earn a stabilization clause from host States in making their investments. What is more common would be certain essential contractual arrangements, or even the pre-contract regulatory framework that has played a considerable role in inducing the investment. Again, whether these arrangements could be considered as specific commitments requires case-by-case analysis. While the *AES Summit Tribunal* found no specific commitments regarding the liberal pricing regime, in another ECT case, *Nykomb v. Latvia*, the Tribunal did confirm the existence of specific commitments concerning the calculation method of electricity purchase price in the contract between Latven-ergo, a state-owned company in charge of electricity purchase and delivery, and Windau, upon which Nykomb relied and made its investment into Windau.⁴⁸

Another scenario where “specific commitments” may also exist is when the host State sets out a series of measures with a special aim to induce foreign investments. As considerable amount of legislative, political and/or contractual arrangements involved, it has always been a controversial issue and less clear to determine. Taking the Argentine privatization movement for example, in the 1990s, the Argentina Government attracted many foreign investments by ambitiously reforming its oil, gas and electricity laws, setting new currency convertibility regime pegging Argentine peso with the US dollar, and making international tenders and “road shows”. The laws, BITs and political leaders of Argentina all emphasized stability of the new legal regime. Yet the advent of the economic cri-

⁴⁵ *Parkerings*, *supra* n29, para. 331; cited in *Micula*, *supra* n14, para. 538.

⁴⁶ *El Paso*, *supra* n9, paras. 375-378.

⁴⁷ *El Paso*, *supra* n9, para. 375.

⁴⁸ *Nykomb Synergetics Technology Holding AB v. The Republic of Latvia*, SCC, Award, 16 December 2003, Section 4.3.2-4.3.3.

sis in 2001 dismantled the whole favorable legal framework, greatly undermined the value of these investments. But when challenging the measures Argentina took in the crisis, Tribunals reached different conclusions with regard to the existence of specific commitments for stabilization at the time of the investment.

For example, in *CMS v. Argentina*, the US investor purchased close to 30% shares in a newly privatized company for gas transportation in 1999, which was granted a 35-year-long license by the Argentine Government. In the analysis of the FET standard, Tribunal found that besides the Gas Law generally bestowing rights such as the right to a fair and reasonable tariff, the Gas Decree and the License specifically provided for the calculation of tariffs in dollars and their conversion into pesos at the time of billing, as well as the adjustment of tariffs in accordance with the US Producer Price Index (“PPI”). The Tribunal deemed it as a guarantee sufficient to legally give rise to a right of the Claimant to that effect.⁴⁹ More importantly, the License contained two legally valid stabilization clauses.⁵⁰ With all this, the Tribunal concluded that CMS received specific commitments from the Government in the stabilization of the legal framework, thus measures taken in the crisis overhauling the whole legal framework, including freezing the tariff and abandoning the dollar calculation breached the FET standard.

In another case, *El Paso v. Argentina*, the Claimant was not as lucky as CMS in establishing the existence of specific commitments. *El Paso* invested in the Argentine oil and electricity industry. The Claimant contended the legal regime and numerous other undertakings bestowed it with reasonable expectation on the stabilization of the rights it enjoyed, including the free export of oil products, exempting hydrocarbon exports from export taxes and withholdings, receiving “capacity payments” and having Spot Prices calculated in dollars.⁵¹ Yet the Tribunal denied these forms of undertakings as protected “specific commitments”. Firstly, the Tribunal rejected the investment-promoting “road shows”, as the occasions and purpose revealed that they were simply political and commercial incitements carrying little legal weight. Then, the Tribunal ruled out the political speeches and relevant decrees with the preamble referring to the enactment objective as setting “clear and definitive rules that guarantee the legal stability”, in the view that such a conclusion “would again immobilize the legal order”. Moreover, the decrees were found actually leaving relevant entities with suf-

⁴⁹ *CMS Award*, *supra* n5, para. 133.

⁵⁰ Clause 9.8 to the effect that the tariff structure would not be frozen or subject to further regulation or price control, and that in the event that a price control mechanism compelled the licensee to adjust to a lower level of tariff “...the Licensee shall be an equivalent amount in compensation to be paid by the Grantor”; Clause 18.2 providing basic rules governing the License would not be amended, totally or partially, without the Licensee’s written consent.

⁵¹ *El Paso*, *supra* n9, paras. 218-219.

ficient regulatory power.⁵² And there was no contractual relationship between *El Paso* and the State generating specific commitments.⁵³

The different conclusions reached between CMS and *El Paso* Tribunal are not contradictory as a matter of fact. The legitimate expectation is an individualized subject. Even in the same macroeconomic background, each investor could have received and relied on different undertakings from host States. One step further, these different undertakings have different ability in generating “reasonable legitimate expectations” and being qualified as “specific commitments”. Two criteria may be set out in assessing the strength of the undertakings.

One is formality. Formalized guarantees generally outweigh informal representations.⁵⁴ As reasoned by the *Continental* Tribunal and shown by the *El Paso* case, political statements carry “the least legal value”. The guarantees by way of open-ended legislation requires more scrutiny, as the enactment is “by nature subject to subsequent modification.”⁵⁵ This point corresponds with our previous discussion on the balance with sovereign States’ regulatory power. What can be seen for certain as “specific commitments” thus narrows down to the “contractual undertakings” (or at least semi-contractual undertakings) with the government, for example, the double tariff regime set out in the contract and in accordance with relevant state regulation in the *Nykomb* case. Concessions granted by the host State to the investors are also typical “contractual undertaking”. Investors can reasonably expect their rights to be stable in the term of concessions and in turn, they would also behave within the framework of concessions.⁵⁶ The guarantees CMS received, for example, were contained in highly formalized sources, including laws, regulations and license contracts.

Another element that plays a core role in determining the existence of specific commitments, especially for host States’ implicit representations and guarantees underlying in the regulatory framework is the “specificity” of the undertaking.⁵⁷

⁵² For example, Presidential Decree No. 186/95, Section 6, established that “the agents and participants of the wholesale electric market (WEM) shall operate pursuant to the regulations issued for such purpose by the Energy Department.”

⁵³ *El Paso*, *supra* n9, paras. 392-416. Indeed concession contracts were granted to the Argentine companies that *El Paso* invested, but the Tribunal found the measures introduced didn’t fundamentally change the functioning of the wholesale electric market. The loss of benefit suffered by *El Paso* was rather largely due to the devaluation of peso, which pertains to Argentina’s fiscal sovereignty that investors were not protected against any adverse change.

⁵⁴ *Thunderbird Separate Opinion*, *supra* n16, para. 31; Costamagna, F., “Investor’ Rights and State Regulatory Autonomy: the Role of the Legitimate Expectation Principle in the CMS v. Argentina case”, *TDM*, (Vol.3, Issue 2, April 2006), p. 13.

⁵⁵ *Continental*, *supra* n13, para. 261.

⁵⁶ Radi, Y., “The Human Nature of International Investment Law”, *TDM*, (Vol. 10, No. 1, January 2013), p. 14. See also, *Suez*, *supra* n6, para. 231.

⁵⁷ *Continental*, *supra* n13, para. 261.

The more specific the target subject is, the more specific the function mechanism is, and the more clear the government's intention to give assurance is, the more likely the existence of specific commitments could be established.

Here, *Micula v. Romania* serves as a good illustration. The Romanian Government set out a legal framework (mainly through the law Emergency Government Ordinance 24 ("EGO 24") in 1998) for granting various incentives to attract investments into certain "disfavored regions". The investors benefiting from such incentives were required to gain Permanent Investor Certificates ("PICs"). The Claimants made investment in the disfavored regions accordingly but Romania withdrew the incentives under the pressure from the EU in 2005. Concerning the existence of specific commitments that bound Romania to grant incentives till 2009, the Tribunal noted firstly, that the EGO 24 regime was set out to direct investment to the regions otherwise unlikely attractive to investments. And it was obvious that long-term investment contributing to employment was preferred.⁵⁸ These findings led the Tribunal to conclude that the interplay of the purpose for EGO 24 regime, the laws, the PICs, and State's conducts, showed Romania "made a representation that created a legitimate expectation that the EGO 24 incentives would be available substantially in the same form as they were initially offered."⁵⁹

So far as we are engaged in examining the strength of single undertakings as specific commitments, we should not ignore the cumulative effects of the undertakings. In the *El Paso* case, while none of the undertakings were established as specific commitments for stability and the measures taken by Argentina, in isolation, were considered as reasonable measures responding the crisis, the Tribunal introduced the concept of "creeping violation of the FET standard" and highlighted that "all the different elements and guarantees just mentioned can be analyzed as a special commitment of Argentina that such a total alteration would not take place." And consequently the measures amounted to a breach of the FET treatment.⁶⁰ The Tribunal cited the words of the LG&E Tribunal, that "Argentina went too far by completely dismantling the very legal framework constructed to attract investors."⁶¹ This touches the boundary of States' regulatory power that we will be discussing in the next Section.

The existence of specific commitments makes the analysis on FET breach simple. Any subsequent regulatory change by a host State, infringing its own

⁵⁸ *Micula*, *supra* n14, paras. 674-689. The EGO 24 set out requirements to fulfill in order to gain the PICs as well as discouragement measures to voluntarily liquidating the companies.

⁵⁹ *Micula*, *ibid*, paras. 677-687.

⁶⁰ *El Paso*, *supra* n9, paras. 517-519.

⁶¹ LG&E, *supra* n14, para. 139; *CMS Award*, *supra* n5, para. 277.

specific commitments, breaches the FET standard.⁶² This is true even if the measures taken are reasonable and follow a transparent procedure and due process. In the *Micula* case mentioned above, the withdrawal of promised incentives was a decision taken under the pressure of the EU, Romania acted in no arbitrary manner. Instead, there was record that Romania had made an effort to negotiate the reservation of said incentives. Nonetheless, the outcome was straightforward: as a result of undermining legitimate expectations, “Romania’s actions, although for the most part appropriately and narrowly tailored in pursuit of a rational policy, were unfair or inequitable vis-à-vis the Claimants.”⁶³

In conclusion, even though specific commitments induced legitimate expectations on stability that are protected within the FET standard, efforts have to be made to prove the existence of such specific commitments and that they are strong enough to bind the host State to act accordingly and to allow no modification.

Legitimate expectations for stability follow an objective test. They have to be genuinely derived out of legal, business and social environment of the host State at the time of making the investment, with due respect to the regulatory rights of host States.

3. REGULATORY CHANGES AFFECTING GENERAL LEGITIMATE EXPECTATIONS

Now, assuming that an investor has obtained reasonable legitimate expectations from the host State for certain degree of stability, even though there are no specific commitments on freezing relevant laws, to what extent and in what manner can the host State exercise its regulatory power so that it would not be considered as a frustration of the investor’s legitimate expectations on stability? The following principles may shed lights in qualifying the host State’s regulatory powers and strike a balance between the investor’s legitimate expectations and the host State’s legitimate right to regulate.

3.1. Reasonableness of the regulatory changes

The high deference that international law extends to the right of States to regulate domestic matters does not mean that such regulatory power is unlimited. The *Impregilo v. Argentina* Tribunal stated:

⁶² *El Paso*, *supra* n9, para. 403.

⁶³ *Micula*, *supra* n14, para. 793, para. 827.

“The legitimate expectations of foreign investors cannot be that the State will never modify the legal framework, especially in times of crisis, but certainly investors must be protected from unreasonable modifications of that legal framework.”⁶⁴

A justifiable regulatory change, and in fact, the justifiable exercising of host State’s regulatory power, has to be reasonable. This reasonableness covers both procedural and substantive aspects.⁶⁵

Procedurally speaking, State conducts have to comply with due process. Bad examples can be seen in *Biwater v. Tanzania*, where the minister abandoned contractual procedure and announced termination of the Claimant’s contract to provide water and sewage service. Tanzania further unilaterally withdrew the company’s VAT exemption, and even occupied the water company’s offices *manu militari*. Without emergency situations, these measures could by no means satisfy the “reasonable” requirement.⁶⁶

Substantively speaking, reasonableness requires the pursuit of a genuine legitimate public interest.⁶⁷ Arbitrary regulatory changes, to which a host State is unable to give satisfactory explanations on economic, social or other grounds,⁶⁸ can hardly hold the water. For example, in *OEPC v. Ecuador*, the Claimant challenged successfully host States’ inconsistent practice in reimbursing value-added tax without proper and sufficient clarifications.⁶⁹ Likewise, State measures driven by discriminatory purpose or political motivation would fall below the FET standard. The refusal of renewing a landfill license, which the investor legitimately expected to be unlimited in terms, was affirmed violating the FET standard in the *Tecmed v. Mexico* case, since it was due to community pressure, and the disguised environmental concerns proved non-existent.⁷⁰

A positive example may be some of the regulatory changes carried out by Argentina in response to the acute economic crisis in 2001-2003, including blocking deposits, prohibition of the free transfer of funds abroad, and pesification of outstanding dollar-denominated contracts and debt.⁷¹ As the *Continental* Tribu-

⁶⁴ *Impregilo S.p. A. v. Argentine Republic*, ICSID Case No. ARB/07/17, Award, 21 June 2011, [hereinafter *Impregilo*], para. 291; *Parkerings*, *supra* n29, paras. 335-336.

⁶⁵ *Micula*, *supra* n14, para. 529.

⁶⁶ *Biwater*, *supra* n6, paras. 500-503.

⁶⁷ See generally, Vandeveldt, K. J., “A Unified Theory of Fair and Equitable Treatment”, *N.Y.U. J. Int’l L. & Pol.*, (Vol.43, 2010), pp. 54-63.

⁶⁸ *El Paso*, *supra* n9, para. 372.

⁶⁹ *Occidental Exploration and Production Company v. The Republic of Ecuador*, LCIA Case No. UN3467, Final Award, 1 July 2004.

⁷⁰ *Tecmed*, *supra* n11, para. 119. Similarly, see *Eureko*, *supra* n43, paras. 232-234.

⁷¹ *Continental*, *supra* n13, para. 137.

nal pointed out, these measures were tailored to prevent the worsening of the economy, and that:

“[t]he Measures were not discriminatory; they were general, affecting all sectors of the national economy and all classes of depositors and investors, nor did they affect the carrying-on of the insurance business of Continental in respect of which the reliance on stability of the legal environment could have been properly focused.”⁷²

If regulatory changes do satisfy the requirement of reasonableness, then, if no specific commitments were given, these regulatory changes would be *prima facie* valid and do not necessarily entail responsibility of the State nor consequential reparation to any aggrieved investor. For instance, as Professor Schreuer points out, an adjustment of environmental regulations to internationally accepted standards or general improvements in Labor Law for the benefit of the host State would not lead to a violation of the FET standard if applied in good faith and without discrimination.⁷³

Then, the analysis switches to another perspective, not in the measures themselves, but in their consequences: while investors foresee reasonable regulatory changes, except in States undergoing fundamental social changes, investors would not expect the regulatory framework to be totally overturned and permanently altered, namely the so-called “roller-coaster” effect as perceived by the PSEG Tribunal.⁷⁴ Also, should there be any restrictions on the manner and extent in pursuing the reasonable public interest objective, posing a requirement of “necessary” similar in the WTO jurisprudence? Would there be differences in justifying a regulatory change that pursues a long-term human rights goal, or that reacts to an unforeseeable emergent situation?⁷⁵

Indeed, “reasonableness” cannot be limited to simply cover the final policy goal and the manner of the measure being neither arbitrary nor discriminatory. Logically, it should also extend to the relationship between the regulatory change measure taken and the final goal pursued. As delicate and controversial issue as it is, the introduction of proportionality principle into the FET standard seems to point a way out.

⁷² *Continental*, *ibid*, para. 262. *Id.*, in *Continental v. Argentina*, there were no legitimate expectations on stability stemmed from specific commitments involved.

⁷³ Schreuer, C., *supra* n6, p. 374.

⁷⁴ PSEG, *supra* n8, para. 250. See also the ongoing cases *Philip Morris Asia Limited v. The Commonwealth of Australia*, PCA Case No. 2012/12 and *Philip Morris Brands Sarl, Philip Morris Products S.A. and Abal Hermanos S.A. v. Oriental Republic of Uruguay*, ICSID Case No. ARB/10/7.

⁷⁵ Radi, Y., *supra* n55, p. 15.

3.2. Proportionality analysis

Proportionality analysis, which stemmed from German administrative and constitutional law, has been increasingly widespread and accepted not only by many other national courts but also distinguished treaty-based international regimes, including the European Court of Human Rights (ECtHR) of the Council of Europe, the EU, and the WTO.⁷⁶ The beauty of proportionality analysis lies in its recognition of two conflicting rights both worthy of protection, and helps restrict excessive harm brought to the counter-party, usually individuals, thus promotes administrative governance.

A classical proportionality analysis involves a three-step reasoning: firstly, “suitability” test, requiring the adopted means rationally linked to the pursued policy objectives. Then, the examination of “necessity” of the measure taken. Usually, a “least-restrictive means” (“LRM”) approach is deployed, proving the non-existence of an alternative that achieves the same government objective but harms the enjoyment of the individual’s right less. Once the government’s measure fails on suitability or necessity, the action is deemed as *per se* disproportionate and the pleaded right of the individual succeeds. The final phase is called “*stricto sensu*”, requiring evidence of realized benefit exceeding the total harm brought to the pleaded right, otherwise the ends pursued by the State must be abandoned and the measure falls as unjustified.⁷⁷

With the proportionality analysis gradually taking its root in global constitutionalism, it becomes generally accepted as a gauge for government decision making.⁷⁸ Investment treaty arbitration, as a branch of public international law, is influenced by this trend. Some arbitral tribunals have made meaningful attempts to incorporate the proportionality test into their reasoning. The *Tecmed v. Mexico* Tribunal is probably the first arbitral tribunal that explicitly referred to proportionality analysis in examining the appropriateness of a government measure. Although the invocation related to the expropriation standard, it is still beneficial to shed some lights on the analysis to see an arbitral tribunal’s approach towards proportionality analysis.

The *Tecmed* case concerned the State agency’s refusal to renew a landfill license. The Tribunal, as usual practice, noted the facts showed that the non-

⁷⁶ See, e.g., Stone Sweet, A., and Mathews, J., “Proportionality Balancing and Global Constitutionalism”, *Yale Law School Faculty Scholarship Series*, 2008, p. 14; Kingsbury, B., and Schill, S. W., “Public Law Concepts to Balance Investors’ Rights with State Regulatory Actions in the Public Interest-The Concept of Proportionality”, SCHILL, S. W. (ed.), *International Investment Law and Comparative Public Law*, Oxford, Oxford University Press, 2010, pp. 79-85.

⁷⁷ See e.g., Tridimas, T., *The General Principles of EU Law*, 2nd Edition, Oxford University Press, Oxford, 2006, pp. 91-92; Kingsbury, B., and Schill, S. W., “Investor-State Arbitration as Governance: Fair and Equitable Treatment, Proportionality and the Emerging Global Administrative Law”, *IIJ Working Paper*, (No. 9, September 2009), pp. 28-30.

⁷⁸ Stone Sweet, A., and Mathews, J., *supra* n75, p. 2.

renewal decision was intense enough to permanently deprive the Claimant of economic interests of its investment. But the analysis did not stop here. Instead, the Tribunal went on to acknowledge that the regulatory administrative actions are not *per se* excluded by the expropriation standard in BIT at issue. Thus, with an aim to reconcile the investor's property interests and the host State's pursuit of public interests, the Tribunal cited jurisprudence from ECtHR and introduced the concept of proportionality:

“[t]here must be a reasonable relationship of proportionality between the charge or weight imposed to the foreign investor and the aim sought to be realized by any expropriatory measure.”⁷⁹

Subsequently, the Tribunal took into account a number of elements, including Tecmed's prior violations of the terms of the operating license, the official inspection stating no indication for health and environmental risks, importance of the regulatory interest pursued, irregular manner in the decision making, as well as Tecmed's legitimate expectations that the Landfill could extend its entire life.⁸⁰ Finally the Tribunal concluded that the degree of the operating company's breaches were marginal and could not be invoked to justify the non-renewal decision. In other words, Tecmed's property rights were disproportionately infringed and indirect expropriation established.

Following *Tecmed*, a number of cases referred to proportionality in their analyses of the expropriation standard, balancing the interests of investors and their legitimate expectations thereon with the pursuit of public interests.⁸¹ However, while legitimate expectations in the expropriation standard involve concrete property interests or the entitlement of investors, legitimate expectations under the FET standard, as discussed above, stretches more broadly and abstractly, on elements such as stability. Yet, the underlying logic of proportionality analysis could still have a role to play. Step by step, the FET standard likewise incorporates proportionality analysis.⁸²

The leading case is *Saluka v. Czech Republic*. Examining the approach taken by the Tribunal, indeed, there was literally no explicit reference to the proportionality analysis. But stating that the determination of the FET breach “requires a weighing of” the Claimant's legitimate expectations and the Respondent's legitimate regulatory interests and that the conduct has to be “reasonably justifiable by

⁷⁹ *Tecmed*, *supra* n11, para. 122.

⁸⁰ *Tecmed*, *supra* n11, para. 123 et seq.

⁸¹ See e.g., *LG&E*, *supra* n14, para. 195; *Methanex*, *supra* n10, Part IV, Chapter D, para. 7; *El Paso*, *supra* n9, para. 241.

⁸² Kingsbury, B., and Schill, S. W., *supra* n76, p. 37.

public policies” and “not manifestly” violate the elements of the FET standard, implies that the Tribunal was conducting a *de facto* proportionality analysis, so as to ensure the measures taken by the host State are suitable and necessary for achieving a genuine public interest.⁸³

If examined carefully, we would also notice that many arbitral tribunals, by referring to the “reasonableness” of government measures or regulatory change, were actually engaging a *de facto* proportionality analysis. For example, in *Pope & Talbot v. Canada*, the Tribunal examined Canada’s transitional quota system adjustment at stake in the proceedings and concluded these measures were reasonable response to the difficulty Canada had faced.⁸⁴ A means-ends analysis actually took place.

The *Saluka* Tribunal’s approach was followed by the *AES Summit* Tribunal, and then succinctly re-interpreted by its *ad hoc* Committee as a “two-pronged test”:

“The first prong of this test requires the identification of a rational policy goal aimed at addressing a matter of public interest. The second requires an assessment of the reasonableness of the measure adopted to implement the policy, including, as the Tribunal noted, the finding of a reasonable correlation between the policy objective and the impugned measure.”⁸⁵

In *AES Summit v. Hungary*, the Tribunal made an effort to hear from experts and examine the negotiating history of the challenged 2006 Electricity Act, to determine the “correlation between the state’s policy objective and the measures adopted to achieve it.” Finally the Tribunal concluded that the 2006 Electricity Act and the implementing Price Decrees were “reasonable, proportionate and consistent with the public policy expressed by the parliament”. Going one step further, the Tribunal affirmed that with the re-introduction of administrative pricing regime, the investors, who were entitled to achieve a 8% return on equity, were still earning a “reasonable return”, implying that the regulatory changes were proportionate and would not excessively harm the investor’s interests.⁸⁶ The proportionality analysis thus was substantially used in the *AES Summit* award, without explicitly referring to or acknowledging its application.

⁸³ *Saluka*, *supra* n17, paras. 306-307.

⁸⁴ *Pope & Talbot, Inc. v. The Government of Canada*, UNCITRAL, Award on the Merits of Phase 2, 10 April 2001, paras. 120-128.

⁸⁵ *AES Summit Generation Limited and AES-Tisza Erőmű Kft v. The Republic of Hungary*, ICSID Case No. ARB/07/22, Decision of the Ad Hoc Committee on the Application for Annulment, 29 June 2012, para. 56.

⁸⁶ *AES Summit Award*, *supra* n37, paras. 10.3.35-10.3.37.

Also, in *Continental v. Argentina*, the Tribunal, when discussing the factors to be examined in determining the FET breach, has similarly expressed the following view:

“centrality to the protected investment and impact of the changes on the operation of the foreign owned business in general including its profitability is also relevant; ... relevance of the public interest pursued by the State, accompanying measures aimed at reducing the negative impact are also to be considered in order to ascertain fairness.”⁸⁷

Therefore, the absence of sufficiently explicit invocation of the proportionality analysis does not undermine its increasing significance in confirming the compliance of the government measures (including regulatory changes) vis-à-vis the State’s international obligations under the FET standard. Sometimes the proportionality analysis was *de facto* invoked under the disguise of “reasonableness”. Indeed there is some overlap between the reasonableness test and the proportionality analysis, as both of them require the genuine public interest objectives, but the former focuses more on the measure itself being justified, not arbitrary or discriminatory by its nature, while the latter lays the emphasis on means-ends relationship, requiring the choice of a measure that entails the least harm to the infringed right to minimize the adverse consequence.

Examining proportionality analysis applied to expropriation cases or the *de facto* proportionality analysis applied to the FET violation contained in the awards so far, arbitral tribunals tend to incorporate the essence of proportionality, e.g., suitability and necessity test, but also allow more flexibility than the three-step model. There seems to be an implied consensus on that the harm brought to investors should not be disproportionate, though so far it is not established that the host State has the obligation to search the “least-restrictive” measure. Also, the *stricto sensu* test has been absent, probably since most cases ended prior to that step. We may perceive that the proportionality analysis is a trend that is likely to occupy a larger role in the upcoming investor-State investment arbitration cases. After all, such logically rational and comprehensive approach is far more convincing than the “I know when I see it” style reasoning.⁸⁸

In conclusion, just as the *El Paso* Tribunal commented, the FET “is a standard entailing reasonableness and proportionality.”⁸⁹ For the regulatory changes to

⁸⁷ *Continental*, *supra* n13, para. 261. iv.

⁸⁸ Kingsbury, B., and Schill, S. W., *supra* n76, p. 23; Fortier Y. and Drymer S. L., “*Indirect Expropriation in the Law of International Investment: I Know It When I See It, or Caveat Investor*”, *ICSID Review Issue*, (Vol. 19, No. 2, 2004), p. 293.

⁸⁹ *El Paso*, *supra* n9, para. 373.

withstand the FET standard, such regulatory changes have to be non-arbitrary, non-discriminatory and reasonably associated with a genuine public interest objective. Host States also have the obligation to make sure the changes are not disproportionately and excessively infringe the rights or legitimate interests of investors.

4. GENERAL JUSTIFICATIONS FOR REGULATORY CHANGES

Nonetheless, host States may still have the possibility to avoid international responsibility even if the regulatory changes go against investors' legitimate expectations (be the general ones or those stemmed from specific commitments) and fall short of reasonableness and proportionality. Two situations may come forth here:

1. firstly, via the so-called non-precluded measures (“NPM”) clause contained in BITs or MITs;
2. or, by way of precluding wrongfulness under the rules of customary international law.⁹⁰

For the latter, the International Law Commission (“ILC”) has recognized various circumstances including countermeasures, force majeure or distress.⁹¹ However, to justify host States' regulatory changes in investor-State investment arbitrations, logically, except for exceptional cases, only necessity could possibly be a relevant defense.⁹² Therefore, this Section focuses the discussions on NPM clauses and customary international law necessity plea, to verify their applicability on justifying host States' regulatory changes.

4.1. Non-precluded Measures Clause

Some BITs/MITs contain NPM clauses.⁹³ States Parties that foresee conflicts between the pursuit of public interests and the protection accorded to investors may introduce such a clause and create a leeway for the free exercise of regula-

⁹⁰ Martin, A., “Investment Disputes after Argentina’s Economic Crisis: ‘Interpreting BIT Non-precluded Measures and the Doctrine of Necessity under Customary International Law’”, *Journal of International Arbitration*, Kluwer Law International 2012, (Vol. 29, No. 1, 2012), p. 50.

⁹¹ Draft Articles on the Responsibility of States for Internationally Wrongful Acts [hereinafter Draft Articles], 53 UN GAOR Supp. No. 10, UN Doc. A/56/10, 2001, Articles 20-27, pp. 48-50.

⁹² For example, Draft Articles, *ibid*, Article 23, p. 48, the plea of force majeure, applies in situations where “an irresistible force or of an unforeseen event, beyond the control of the State,” in which States generally have no sufficient time/means to legislate or end up in finding themselves legislate in vain.

⁹³ See e.g., ECT, *supra* n3, Article 24.

tory power. This trend is on the rise in modern investment treaties.⁹⁴ Some NPM clauses apply vis-à-vis all treaty provisions,⁹⁵ while others may cover measures specifically falling under one standard of protection.⁹⁶ NPM clauses often link the measures with certain public interest objectives, e.g. security, public order, health and morality, although rarely such exception clauses specifically refer to economic interests as a justifiable goal.⁹⁷ If the States Parties agreed on a NPM clause under the FET standard or a general NPM clause applicable to all provisions and the host State invoked in to justify the challenged regulatory changes, arbitral tribunals would have to examine whether the challenged regulatory changes comply with the conditions set out in the NPM clause.

But before further studying the application of the NPM clause, one question has to be answered in advance: is the NPM clause a separate defense that takes precedence of customary international law necessity defense, or is it simply a manifestation of the latter? The answer to this question is crucial, as a negative answer suggests that discussions should rather be prioritized at the customary international law defense.

4.1.1. Relationship with the necessity plea

The limited case law discussing the NPM clause defense mainly involves Article XI of US-Argentina BIT,⁹⁸ which Argentina invoked to justify its regulatory changes made during the economic crisis in 2001-2003 as far as US investors were concerned.⁹⁹ In the arbitral proceedings, Argentina also made a customary

⁹⁴ Burke-White, W. W., and von Staden, A., "Investment Protection in Extraordinary Times: Interpreting Non-precluded Measures Provisions", *Va. J. Int'l L.*, (Vol. 48, No. 2, 2007), p. 318.

⁹⁵ For example, Agreement for the Promotion and Protection of Investments, India-United Kingdom, March 1994, 1995 India T.S. No. 27, Article 11(2): "nothing in this Agreement precludes the host Contracting Party from taking action for the protection of its essential security interests or in circumstances of extreme emergency in accordance with its laws normally and reasonably applied on a non-discriminatory basis."

⁹⁶ For example, China-Germany BIT, *supra* n2, Protocol to the Agreement between the People's Republic of China and the Federal Republic of Germany on the Encouragement and Reciprocal Protection of Investments, Article 4(a): "Measures that have to be taken for reasons of public security and order public health or morality shall not be deemed 'treatment less favorable' within the meaning of Article 3."

⁹⁷ Salacuse, J. W., *The Law of Investment Treaties*, Oxford University Press, Oxford, 2009, p. 343.

⁹⁸ Treaty Between United States of America and the Argentine Republic concerning the Reciprocal Encouragement and Protection of Investment, 31 I.L.M 124, adopted 14 November 1991, entered into force 20 October 1994, Article XI: "This Treaty shall not preclude the application by either Party of measures necessary for the maintenance of public order, the fulfillment of its obligations with respect to the maintenance or restoration of international peace or security, or the Protection of its own essential security interests."

⁹⁹ *CMS Award*, *supra* n5; *LG&E*, *supra* n14; *Enron Corporation Ponderosa Assets, L.P. v. Argentine Republic*, ICSID Case No. ARB/01/03, Award, 22 May 2007, [hereinafter *Enron*]; *Sempra Energy International v. Argentine Republic*, ICSID Case No. ARB/02/16, Award, 28 September 2007, [hereinafter *Sempra*]; *Continental*, *supra* n13; *El Paso*, *supra* n9.

international law necessity plea, and Tribunals departed on their understanding of the relationship between the two defenses, which subsequently led to different interpretations of the NPM clause. Some implicitly equated both defenses by incorporating the requirements of necessity defense into the analysis of the NPM clause¹⁰⁰ or explicitly rejected understanding Article XI as *lex specialis* on the grounds that the Treaty failed to present “a treaty regime specifically dealing with a given matter” that would supersede the application of the customary international law;¹⁰¹ while other Tribunals appeared to understand Article XI as a distinct defense, presenting a standard confirming Argentina “has no choice but to act”, different from the “only means” under customary international law necessity plea.¹⁰²

As dispersed viewpoints as they are, a more convincing approach was put forward by the *ad hoc* Committee in the CMS Award annulment proceedings.¹⁰³ The Committee affirmed that Article XI was *lex specialis* and shall be applied in a sequence prior to the customary international law necessity plea as a primary rule.¹⁰⁴

The equation of a NPM defense with a customary international law necessity defense is problematic in several ways. First of all, the substantive construction of a NPM clause and customary international law necessity defense, which is exemplified in Article 25 of ILC’s Draft Articles,¹⁰⁵ is different. Usually a NPM clause is drafted in a positive way, appearing itself to be “a threshold requirement: if it applies, the substantive obligations under the Treaty do not apply.”¹⁰⁶ Whereas the necessity plea is drafted in a negative way and requires a number of strict

¹⁰⁰ CMS Award, *supra* n5, paras. 353-358. See also, Alvarez, J. E., and Khamis, K., “The Argentine Crisis and Foreign Investors: A Glimpse into The Heart of The Investment Regime”, *IIJ Working Paper*, (No. 5, 2008), p. 16.

¹⁰¹ *Enron*, *supra* n98, para. 334. The Tribunal also held that the Treaty lacked definition of “essential security interests”, so it’s necessary “to rely on the requirements of state of necessity under customary international law.”

¹⁰² *LG&E*, *supra* n14, para. 239.

¹⁰³ *CMS Gas Transmission Company v. The Argentine Republic*, ICSID Case No. ARB/01/8, Decision of the Ad Hoc Committee on the Application for Annulment of the Argentine Republic, 25 September 2007, [hereinafter *CMS Annulment Decision*]. It should be noted that even though the *ad hoc* Committee raised several points as the manifest errors that the CMS Tribunal had made in the law application concerning the Article XI and customary international law necessity plea, the *ad hoc* Committee did not annul the CMS award on this part due to its limited jurisdiction under Article 25 of the ICSID Convention.

¹⁰⁴ *CMS Annulment Decision*, *ibid*, paras. 128-136. This view is also shared by scholars such as Burke-White, W. W., and von Staden, A., see *supra* n93, pp. 321-323.

¹⁰⁵ See e.g., *Gabčíkovo–Nagymaros Project (Hungary/Slovakia)*, Judgment of 25 September 1997, [hereinafter *Gabčíkovo–Nagymaros*], I.C.J. Reports 1997, p. 7, though at that time necessity was Article 33 of ILC’s Draft Articles; *LG&E*, *supra* n14, para. 245; *CMS Annulment Decision*, *supra* n102, para. 130.

¹⁰⁶ *CMS Annulment Decision*, *supra* n102, para. 129.

conditions to be fulfilled simultaneously by the State.¹⁰⁷ Thus NPM clauses apply less restrictively. The triggering of the NPM clause does not require “essential interests in peril” and exempts a State from responsibility as long as “actions are sufficiently related to particular State objectives.”¹⁰⁸ This implies that the inclusion of customary international law requirements for the necessity defense into the interpretation of a NPM clause, e.g. no serious impairment of the interests of the other State,¹⁰⁹ is not firmly grounded.¹¹⁰

The problem of the equation of a NPM clause with the customary international law defense also lies in the hierarchy of the application of international law rules. The ILC itself explicitly recognized the necessity plea as a secondary rule.¹¹¹ Whereas a NPM clause, like Article XI, is negotiated by States Parties as a primary international law rule that limits the applicability of an international treaty with respect to certain types of conduct.¹¹² Therefore, the NPM clause, if any, should be given a play first. Only a failure in justification by the NPM clause or no existence of a NPM clause at all would make it necessary to examine the satisfaction of necessity plea.¹¹³ Furthermore, customary necessity defense is used to “exclude wrongfulness”. It is concerned about the issue of responsibility.¹¹⁴ Therefore, it requires that a State is established as having conducted an internationally wrongful act. A NPM defense, however, does not need “wrongfulness” as a prerequisite. Rather, the successful justification through a NPM clause means “the substantive obligations under the Treaty do not apply”¹¹⁵ and thus “‘no breach’ of the BIT” at all has taken place.¹¹⁶

¹⁰⁷ See *infra* p. 25 et seq.

¹⁰⁸ Burke-White, W. W., and von Staden, A., *supra* n93, p. 321.

¹⁰⁹ CMS Award, *supra* n5, paras. 353-358.

¹¹⁰ CMS Annulment Decision, *supra* n102, para. 130.

¹¹¹ Draft articles on Responsibility of States for Internationally Wrongful Acts, with Commentaries, “Report of International Law Commission on the work of its fifty-third session”, *Yearbook of the International Law Commission*, Vol. II, Part Two, 2001, [hereinafter ILC’s Commentaries], Article 25, para. 21, p. 84, stating “the plea of necessity is not intended to cover conduct which is in principle regulated by the primary obligations.” See e.g. Crawford, J., “The ILC’s Articles on Responsibility of States for Internationally Wrongful Acts: A Retrospect”, *The American Journal of International Law*, (Vol. 96, No. 4, October 2002), p. 876.

¹¹² Burke-White, W. W., and von Staden, A., *supra* n93, p. 322.

¹¹³ CMS Annulment Decision, *supra* n102, para. 134; Burke-White, W. W., and von Staden, A., *supra* n93, p. 322.

¹¹⁴ See ILC’s Commentaries, *supra* n110, para. 1, p. 80.

¹¹⁵ CMS Annulment Decision, *supra* n102, para. 129.

¹¹⁶ CMS Annulment Decision, *ibid*, para. 133. Also, The CMS *ad hoc* Committee discussed the possibility of the necessity plea being understood as a primary international rule and its successful invocation leads to the conclusion of no *prima facie* breach of BIT. In other words, if it is a primary international law rule same as Article XI covering the same subjects. Even in such circumstances, the NPM clause should still be applied first because it is *lex specialis*.

Burke-White and von Staden, citing WTO precedent,¹¹⁷ likewise warned that “[r]educing the NPM clause to merely a treaty-based reiteration of the necessity defense would violate the principle of effectiveness in treaty interpretation (*ut res magis valeat quam pereat*).”¹¹⁸

Therefore, it is reasonable to conclude that, in accordance with international law, the NPM clause found in a treaty should be subject to its own interpretation. It is a separate defense from the customary international law necessity plea, and should be examined prior to the necessity plea. As a matter of fact, the successful satisfaction of a NPM clause excludes the challenged measure from the substantive standards of protection from the BIT/MIT at stake. Without being bound by an international obligation, there would be no internationally wrongful act that entails the international responsibility of a State which needs to be justified by a defense like “state of necessity”.¹¹⁹

4.1.2. Interpretation of a NPM clause

Having clarified that a NPM clause functions in a different way than the necessity plea, the issue in interpreting the NPM clause still remains to be solved. As discussed, as a *lex specialis*, a NPM clause is to be interpreted differently according to how States Parties to the treaty empower it.¹²⁰ Again, the classical interpretation approach under Articles 31 and 32 of the Vienna Convention on the Law of Treaties (“VCLT”) has to be observed.¹²¹ There is no shortcut. States Parties may not necessarily give one term the identical meaning as the exact term that appears in any other treaty they enter into. Full analysis must be made vis-à-vis the ordinary meaning, context, object and purpose, etc.

The Argentine cases tribunals, taking into account legislation developments, comparative treaty clauses and party positions at that time, reached one consensus in their interpretation of Article XI: it is not a self-judging

¹¹⁷ WTO Appellate Body Report, *United States-Standards for Reformulated and Conventional Gasoline*, WT/DS2/AB/R, 29 April 1996: “[o]ne of the corollaries of the “general rule of interpretation” in the Vienna Convention is that interpretation must give meaning and effect to all the terms of a treaty. An interpreter is not free to adopt a reading that would result in reducing whole clauses or paragraphs of a treaty to redundancy or inutility.”

¹¹⁸ Burke-White, W. W., and von Staden, A., *supra* n93, p. 323.

¹¹⁹ Draft Articles, *supra* n90, Articles 1-2, p. 43.

¹²⁰ Burke-White, W. W., and von Staden, A., *supra* n93, pp. 322-323. In contrast, the necessity functions in a uniform manner across the world, which is the nature of customary international law.

¹²¹ Vienna Convention on the Law of Treaties, United Nations, 23 May 1969, 1155 U.N.T.S. 331, 8 I.L.M. 679, Articles 31-32.

standard, which means that the host State, Argentina, could not be seen as the sole judge on the legitimacy of the measures taken, as well as “the scope and application of that rule, or whether the invocation of necessity, emergency or other essential security interests is subject to some form of judicial review”.¹²² The Argentine cases tribunals agree that, if States Parties would like such clauses to be self-judging, they would do it expressly, and normally they must draft it expressly to reflect such intent,¹²³ such as the 2012 US Model BIT:

“Nothing in this Treaty shall be construed: ... to preclude a Party from applying measures *that it considers* necessary for the fulfillment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interest.”¹²⁴ *[Emphasis added]*

If the NPM clause is a self-judging one, then the State’s action would be subject to a good faith review, thus the standard for legitimacy of government’s regulatory change would be considerably lowered.¹²⁵ However, in any event, the measures taken require a rational basis, otherwise the State would fail to justify *prima facie* the measures link to the pursuit of the justifiable goal.

On the contrary, be the NPM clause not self-judging, the State cannot justify its measures simply by stating that it is acting in good faith and believes the measure taken helps achieve the permissible goal of the NPM clause. Then, “[i]t is necessary to show that those measures were effectively covered by the language of Article XI.”¹²⁶ A full review guided by VCLT has to take place to certify the content of the NPM clause.

And what is the gauge to decide the nexus in the NPM clause, e.g. that a measure is “necessary to” or “has to be taken” in furtherance of the public interest goal? In a non-self-judging NPM clause, with limited case law at hand for guidance, the conclusion has not been clear yet. Arguably, it may then be left to a tribunal exercise its own margin of appreciation and decide on the legitimacy of the State’s freedom of action under the treaty.¹²⁷ This

¹²² See e.g. *CMS Award*, *supra* n5, paras. 366-370; *El Paso*, *supra* n9, para. 589.

¹²³ See e.g. *CMS Award*, *supra* n5, para. 370; *Enron*, *supra* n99, paras. 335-339; *Sempra*, *supra* n98, paras. 378; *Continental*, *supra* n13, para. 188.

¹²⁴ U.S. Model BIT, *supra* n4, Article 18(2).

¹²⁵ *LG&E*, *supra* n14, para. 214; Salacuse, J. W., *supra* n96, p. 345.

¹²⁶ *El Paso*, *supra* n9, para. 595.

¹²⁷ Burke-White, W. W., and von Staden, A., *supra* n93, p. 375.

view seems to be implicitly agreed and applied by *El Paso Tribunal*, as it stated:

“However, having found that Article XI is not ‘self-judging,’ the Tribunal *has the power and duty* to make sure that all conditions for its application are satisfied, including the absence of a substantial contribution by Argentina to the crisis of 2001.”¹²⁸ [*Emphasis added*]

Interestingly, the proportionality analysis may also find its applicability within the non-self-judging NPM clause, as the *Continental Tribunal* had already made, by introducing WTO jurisprudence to determine whether Argentina’s measures were covered by Article XI as “necessary for the maintenance of public order.”¹²⁹ With such application, if regulatory changes have been deemed as unreasonable or disproportionate in previous analysis, it is difficult to envisage that they could later be covered by the non-self-judging NPM clause.¹³⁰

4.2. Necessity under customary international law

The necessity defense is generated from the natural right of States to self-preservation.¹³¹ Should the essential interests of a State be at stake, allowance shall be given to a State to eviscerate certain obligations it bears to survive.¹³² Yet, as the counter-party to the necessity plea has done nothing wrong to trigger the situation of necessity of the invoking party, and the State justifying the internationally wrongful act with the necessity plea “implies a perfect awareness of having deliberately chosen to act in a manner not in conformity with an international obligation,”¹³³ case law of the International Court of Justice (“ICJ”) held that “necessity was viewed as unique and even more rarely admissible than is the case with the other circumstances precluding wrongfulness.”¹³⁴ In other words, it has to be invoked restrictively.¹³⁵

¹²⁸ *El Paso*, *supra* n9, para. 665.

¹²⁹ *Continental*, *supra* n13, paras. 173-230; Kingsbury, B., and Schill, S. W., *supra* n75, pp. 98-102.

¹³⁰ Newcombe, A., “General Exceptions in International Investment Agreements”, in Cordonier Segger, M.-C., Gehring, M. W. and Newcombe, A. (ed.), *Sustainable Development in World Investment Law*, Kluwer Law International, United Kingdom, 2011, p. 369.

¹³¹ Ago, R., “Addendum to the Eight Report of State Responsibility”, [hereinafter Ago Report], *Yearbook of the International Law Commission*, UN Doc.A/CN.4/318/ADD.5-7, (Vol. II, 1980), p. 17.

¹³² Ago Report, *ibid*.

¹³³ Crawford, J., *Addendum to Second Report on State Responsibility*, [hereinafter James Crawford’s Second Report], UN A/CN.4/498/Add.2, (April 1999), para. 276.

¹³⁴ *Gabčíkovo–Nagymaros*, *supra* n104, p. 40. See also, *Impregilo*, *supra* n63, para. 344.

¹³⁵ *LG&E*, *supra* n14, para. 248; *BG Group, Plc. v. The Argentine Republic*, UNCITRAL, Final

The invocation of the necessity plea was codified in Article 25 of ILC's Draft Articles,¹³⁶ which has been regarded as reflecting customary international law.¹³⁷ A successful resort to Article 25 requires a satisfaction cumulatively of all elements.¹³⁸ This article, with its focus on regulatory changes, will select several points that are likely to block the justification of the challenged regulatory changes.

4.2.1. *Essential interest of the State*

An essential interest of State at stake is the first and foremost condition to invoke necessity (Article 25.1(a)). As James Crawford commented, no *a priori* definition of an essential interest can be offered. "The extent to which a given interest is 'essential' naturally depends on all the circumstances in which the State is placed in different specific situations; the extent must therefore be judged in the light of the particular case into which the interest enters, rather than be predetermined in the abstract."¹³⁹

This interest must be vital, such an impairment which "threats to a State's political or economic survival, the continued functioning of its essential services, the maintenance of internal peace, the survival of a sector of its population, the preservation of the environment of its territory or a part thereof, etc."¹⁴⁰ Affirmatively, it covers far more interests than the political independence of a State, and a grave economic circumstance threatening the host State's economic survival may give rise to a necessity defense. The same criteria is applied to "ecological balance", confirmed in the *Gabčíkovo-Nagymaros* case.¹⁴¹ Yet, as said, the very na-

Award, 24 December 2007, [hereinafter *BG Group*], para. 410.

¹³⁶ Draft Articles, *supra* n90, Article 25, p. 9. The Article 25 goes as follows:

"1. Necessity may not be invoked by a State as a ground for precluding the wrongfulness of an act not in conformity with an international obligation of that State unless the act:

(a) Is the only way for the State to safeguard an essential interest against a grave and imminent peril; and
(b) Does not seriously impair an essential interest of the State or States towards which the obligation exists, or of the international community as a whole.

2. In any case, necessity may not be invoked by a State as a ground for precluding wrongfulness if:

(a) The international obligation in question excludes the possibility of invoking necessity; or
(b) The State has contributed to the situation of necessity."

¹³⁷ *Gabčíkovo-Nagymaros*, *supra* n104, though at that time necessity was Article 33 of ILC's Draft Articles. See also, *LG&E*, *supra* n14, para. 245, *CMS Annulment Decision*, *supra* n102, para. 130.

¹³⁸ See, e.g., *Gabčíkovo-Nagymaros*, *supra* n104, p. 40; *CMS Award*, *supra* n5, para. 331; *Enron*, *supra* n98, para. 313.

¹³⁹ James Crawford's Second Report, *supra* n132, para. 281.

¹⁴⁰ Ago Report, *supra* n130, p. 19.

¹⁴¹ *Gabčíkovo-Nagymaros*, *supra* n104, p. 41.

ture of necessity requires a restrictive interpretation of Article 25.¹⁴² Therefore, it is unlikely that an interest of safeguarding financial order and fighting against fraud or money laundering, etc., though public interests for sure, would be upheld as an “essential interest”, as they are not linked closely enough to the survival of the State or its people. In other words, the related regulatory changes may fail the necessity plea in the first step.

4.2.2. *Grave and imminent peril*

Meanwhile, the established “essential interest” has to be genuinely at stake. (Article 25.1(a)). Judging from arbitral practice, it seems that arbitral tribunals have exercised their own appreciation of facts and led to considerable uncertainty in the end result.

In the Argentine cases, the *LG&E* Tribunal concluded that Argentina was faced with factual and legislative emergency, not merely a business cycle but that “[e]xtremely severe crises ... threatening total collapse of the Government and the Argentine State.”¹⁴³ The *Impregilo* Tribunal well confirmed the gravity of the peril, citing facts such as the succession of five presidents in ten days and United Nations General Assembly’s first ever suspension of membership fee.¹⁴⁴ The *Enron* and *Sempra* tribunals, on the other hand, perceived the peaceful transition of presidencies and related facts oppositely, and found the crisis, albeit severe, “did not compromise the very existence of the State and its independence.”¹⁴⁵

In international law, the ICJ in the *Gabčíkovo-Nagymaros* case set for the threshold that “peril” had to be established objectively and be “imminent”, which stands for “proximity”, going far beyond the concept of “possibility”.¹⁴⁶ In other words, any essential interests not under acute threat would not be able to trigger necessity successfully. However, in situations where the state of necessity has not yet realized, but a peril can clearly be established with scientific evidence as inevitable, the ILC and ICJ acknowledged that the State is not pre-barred from invoking necessity.¹⁴⁷

Therefore, what really matters regarding this issue is the establishment of such an essential interest under real or inevitable grave peril. Shedding lights on regu-

¹⁴² See e.g., James Crawford’s Second Report, *supra* n132, para. 276. See also, e.g. *LG&E*, *supra* n14, para. 248; *BG Group*, *supra* n134, para. 410.

¹⁴³ *LG&E*, *supra* n14, paras. 226-237, 257.

¹⁴⁴ *Impregilo*, *supra* n63, paras. 348.

¹⁴⁵ *Enron*, *supra* n98, paras. 306-307; *Sempra*, *supra* n98, paras. 348-349.

¹⁴⁶ *Gabčíkovo-Nagymaros*, *supra* n104, p. 42.

¹⁴⁷ ILC’s Commentaries, *supra* n110, Article 25, para. 15, p. 83; *Gabčíkovo-Nagymaros*, *supra* n104, p. 42.

latory changes, when such changes are designed to promote public health, human rights and environment protection in the long run, and no emergency happens that puts such interests under peril or sufficient scientific evidence showing that without such protection measures, the peril would be inevitable; the justification by way of necessity might fail. The lack of imminent peril was exactly one of the reasons why Hungary failed to justify its refusal to honour its treaty obligation to construct a reservoir in the *Gabčíkovo-Nagymaros* case. The possible adverse environmental impact of the project's impact on the Danube River was deemed not imminent enough.

4.2.3. *Only means*

The successful invocation of the necessity plea requires the State has no other means but the challenged measures to overcome the emergent situation (Article 25.1(a)). This entails, according to Professor James Crawford, that an alternative shall always be adopted as long as it reaches the same result, even if more costly or less convenient.¹⁴⁸ In the *Gabčíkovo-Nagymaros* case, the ICJ rendered Hungary's measures unjustified also on the grounds that it was able to identify a number of alternative measures for Hungary to monitor and control the water quality of the Danube River.¹⁴⁹

In the event of economic emergency, when the host State raises the necessity plea to justify its regulatory changes, the "only means" requirement tends to be a hard hurdle to overcome. As exemplified in the CMS Award, the Tribunal acknowledged that divergent views existed, yet nonetheless concluded the measures taken were not the only solution possible, and whether they were superior ones were beyond the Tribunal's task.¹⁵⁰ The *Enron* and *Sempra* tribunals also doubted that the measures taken were the only means, though likewise had not specified any alternatives.¹⁵¹ The *LG&E* Tribunal however, confirmed the satisfaction of this element. Yet its approach was questionable: it regarded the measures as an economic recovery package, and concluded that implementing an economic recovery package was the only means to tackle the economic crisis.¹⁵² Whether the "one-way-out" characteristic for an economic recovery measure as a package can justify single measures within it as the "only means" is debatable.

¹⁴⁸ Crawford, J., *The International Law Commission's Articles on State Responsibility: Introduction, Text and Commentaries*, Cambridge University Press, Cambridge and New York, 2002, p. 184.

¹⁴⁹ *Gabčíkovo-Nagymaros*, *supra* n104, p. 44.

¹⁵⁰ CMS Award, *supra* n5, para. 323.

¹⁵¹ *Enron*, *supra* n98, para. 308; *Sempra*, *supra* n98, para. 350.

¹⁵² *LG&E*, *supra* n14, para. 257.

Given the tendency on traditional customary international law to construe the “only means” requirement strictly, there are now developments arguing for a relatively relaxed approach.¹⁵³ It is said the purpose for the “only means” requirement was to ensure that the causal connection between the safeguarding of the essential interests of State and the means chosen is close enough. Therefore, overly literal reading of “only means” would tend to negate the entire doctrine. Moreover, again a number of scholars promoted the proportionality analysis, contending that it helps “preserve the availability of the defense without sacrificing the gate-keeping nature of the condition.”¹⁵⁴

4.2.4. *Non-self-contribution*

The State that has contributed to the situation of necessity itself would fail the invocation of the necessity plea (Article 25.2(b)). The ILC interpreted in its Commentary to Draft Articles that the contribution “must be sufficiently substantial and not merely incidental or peripheral.”¹⁵⁵

There definitely exists the possibility where an essential interest of a State is under peril, and the invoking State is in absolute clean hands. But normally reality is not black-and-white.¹⁵⁶ In the Argentine cases, it has been hotly debated whether Argentina had itself contributed to its economic crisis. Indeed, the crisis was contributed or worsened by both of endogenous and exogenous factors. The CMS Tribunal took the lead in concluding that “government policies and shortcomings significantly contributed to the crisis and the emergency”, therefore, the exogenous factors “did not exempt the Respondent from its responsibility in the matter.”¹⁵⁷ The LG&E Tribunal departed in the reasoning, stating that Claimant had failed to prove Argentina’s contribution and the Government did try to slow down the crisis by all means.¹⁵⁸ Nonetheless, this approach stands as unique and isolated.¹⁵⁹ More resonates were seen in the CMS approach. For example, *El*

¹⁵³ Bjorklund, A., K., “Chapter 16: *The Necessity of Sustainable Development?*”, in Cordonier Segger, M.-C., Gehring, M. W. and Newcombe, A. (ed.), *Sustainable Development in World Investment Law*, Kluwer Law International, United Kingdom, 2011, p. 387.

¹⁵⁴ See e.g., Bjorklund, A., K., “*Economic Security Defenses and International Investment Law*”, *Yearbook on International Investment Law and Policy 2008–2009*, in Sauvant, K., P., (ed.), Oxford University Press, New York, 2009, p. 479; Reinisch, A., “*Necessity in International Investment Arbitration—An Unnecessary Split of Opinions in Recent ICSID Cases? Comments on CMS v. Argentina and LG&E v. Argentina*”, *TDM*, (Vol. 3, No. 5, 2006), pp. 12.

¹⁵⁵ Crawford J., *supra* n147, p. 185.

¹⁵⁶ See, e.g., *Enron*, *supra* n98, paras. 311-312; *Sempra*, *supra* n98, paras. 353-354.

¹⁵⁷ *CMS Award*, *supra* n5, para. 329.

¹⁵⁸ *LG&E*, *supra* n14, para. 256.

¹⁵⁹ Bjorklund, A., K., “*Emergency Exceptions: State of Necessity and Force Majeure*”, Muchlinski, P., Ortino, F., and Schreuer, C. (ed.), *The Oxford Handbook of International Investment Law*, Oxford Univer-

*Paso Tribunal*¹⁶⁰, *Impregilo Tribunal*¹⁶¹ and *National Grid Tribunal*¹⁶² examined the various reports and comments from the International Monetary Fund (“IMF”), officials, professors of law and economics, etc., and concluded that Argentina had played a role in the contribution; one example would be “Argentina’s long-term failure to exercise fiscal discipline.”¹⁶³ Such conclusions were drawn even with the discovery of facts stating that much of the measures prior to economic crisis were taken with guidance under the IMF.¹⁶⁴ Therefore, the “clean hands” in customary international necessity plea is indeed a relatively high standard to reach in investor-State arbitrations.

To wrap up, were there NPM clauses in the BIT or MIT at stake, the host State may invoke the NPM clause to justify its regulatory change. In such case, the interests pursued need not be in peril. If the relevant NPM clause is self-judging, the host State needs only pass a good faith review. If it is a non-self-judging one, then full review has to be conducted to certify the intention of States Parties when drafting the clause. And arbitral tribunals may exercise their margin of appreciation in assessing the facts. Therefore, if the regulatory change was not reasonable and proportionate, it is uncertain whether such regulatory change can be justified with a non-self-judging NPM clause. The customary international law plea of necessity is always available but it requires the emergent situations to pose real, grave and imminent peril to essential interests of the State and the State did nothing to contribute to such emergency. Plus other restricting conditions under Article 25 of ILC’s Draft Articles, it appears to be difficult for a State to successfully invoke and preclude its wrongfulness on breaching the FET and other standards of an international treaty.

5. CONCLUSIONS

First, host States have an inherent sovereign power to make regulatory changes to adapt to new developments. This right is undeniable, but host States’ international obligations towards foreign investors is equally undeniable, should they entered into investment treaties and have voluntarily taken on certain standards of treatment.

sity Press, 2008, p. 471.

¹⁶⁰ *El Paso*, *supra* n9, para. 656 et seq.

¹⁶¹ *Impregilo*, *supra* n63, para. 330 et seq.

¹⁶² *National Grid*, *supra* n6, para. 260.

¹⁶³ *Impregilo*, *supra* n63, para. 358.

¹⁶⁴ *El Paso*, *supra* n9, para. 659.

Second, fair and equitable treatment (“FET”), with its emphasis on guaranteeing normal operation of law-abiding business activities and the indeterminacy of its contents, tends to be a standard frequently buttressed by aggrieved investors in their claims against host States. Invoking the FET to challenge regulatory changes of the host State is likely to be accompanied by the argument of legitimate expectations for stability. However, such legitimate expectations may not necessarily exist universally for all foreign investments. Therefore, verifying if and what legitimate expectations existed at the time of making the investment is a crucial process in dealing with such claims.

Third, the verification of the existence of legitimate expectations follows an objective test. All business, social and legal circumstances of the host State at the time of the making of investment and those influenced the investors’ decisions have to be taken into account by the organ judging the investors’ claims (normally an international arbitral tribunal). Were the investment induced by specific commitments offered by a host State and entailed specific commitments the obligation on the host State to stabilize certain laws or contractual arrangements, the investors could legitimately expect such promised stability and hold the host State in violation of FET if it acts adversely.

Forth, however, if no such specific commitments have existed, due deference and flexibility are bestowed on host States to exercise their sovereign rights and carry out *bona fide* new regulations. Investors who received no specific commitments would find it difficult to justify their expectations on the total stabilization of the legal framework. Arbitral tribunals are also cautious not to interpret general legislation as an equation of a stabilization clause, to avoid the effect of immobilization of the legal order. In these cases, the regulatory changes would not be *per se* violations of FET. However, there still exists legitimate expectations on the fairness and certain degree of stability by the host State. Furthermore, most States would be in breach of the FET standard if the challenged regulatory changes are unreasonable, e.g., arbitrary or discriminatory in nature, not pursuing genuine public interests, or not following the due process.

Fifth, a specific commitment can be addressee-specific or objective-specific, and it may exist in various forms. Yet, different undertakings by host States have varied ability to generate legitimate expectations on stability, depending on their formality and the “specificity”. This is worthy of investors’ caution and diligence. The more specific the target subjects are, the more clear the function mechanism is, the more explicit the governments’ intention to give assurance is, the more likely specific commitments exist. Guarantees and representations in a contractual relationship are the safest form of specific commitment, whereas public statements are subject to doubts on their legal validity. The cumulative effects of

guarantees may also formulate a special specific commitment on no fundamental change of the regulatory framework.

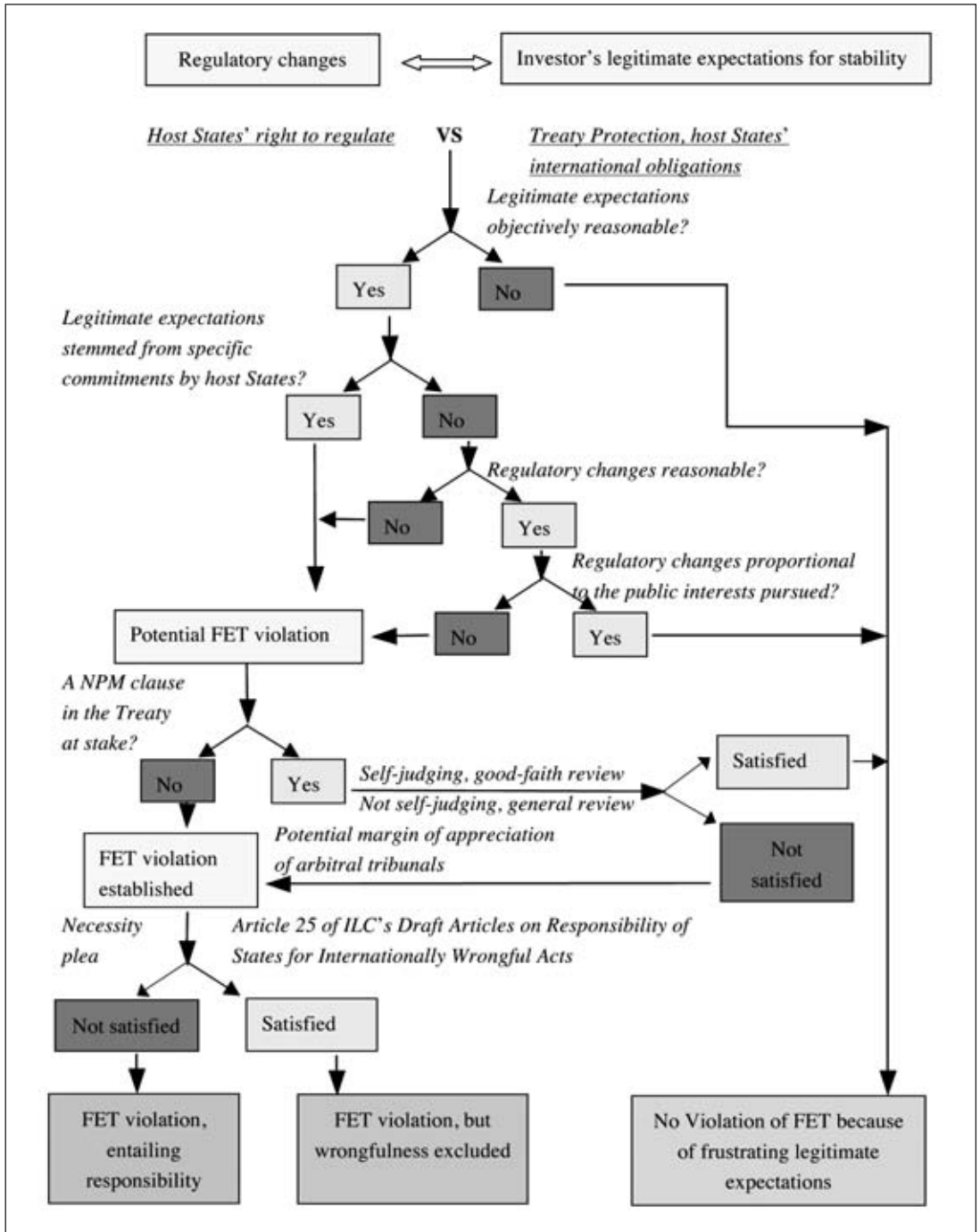
Sixth, increasing arbitral practice absorbs elements of the proportionality test, which emphasizes the measures taken in pursuit of the public interests should not bring about excessive burdens to the legitimate interests of individuals. Arbitral tribunals tend to follow a flexible approach, e.g. the “two-pronged” test. Some have exercised a *de facto* proportionality test in the disguise of examining “reasonableness” of regulatory changes. Accumulated arbitral jurisprudence calls for the States to search for a better tailored measure in order to be justified as the legitimate exercise of their regulatory powers.

Seventh, in an event of a potential or established FET breach due to the frustration of investors’ legitimate expectations, the host State may nonetheless be exempted from international responsibility through two mechanisms: a Non-Precluded Measures clause that may be contained in investment treaty and the customary international law defense of necessity. The NPM clause, as a primary rule and *lex specialis*, shall be examined prior to the necessity defense. Once the conditions of the NPM clause are satisfied, the challenged regulatory changes in pursuit of the very public interests are deemed as not covered by the treaty protection and thus no breach of FET would have existed.

Eighth, a self-judging NPM clause requires only good faith from host States, whereas a non-self-judging NPM clause needs treaty interpretation and arbitral tribunals may have the opportunity to exercise their margin of appreciations to examine the measures’ compatibility with treaty obligations. Proportionality analysis may again be introduced, thus a regulatory change that fail in the previous analysis to meet the FET standard is still difficult to be justified by a NPM clause.

Ninth, the customary international law necessity defense, if invoked successfully, would help the host State’s to exclude wrongfulness, but the breach of the treaty standard would be confirmed. However, it requires host States to fulfill all the conditions listed in Article 25 of Draft Articles on Responsibility of States for Internationally Wrongful Acts simultaneously. Thus, this invocation has to pass a much stricter test compared to a NPM clause justification, and less likely to be successful.

6. ANALYSIS FLOW CHART



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