Restrictive Interpretation of Investors’ Legitimate Expectations in the Fair and Equitable Treatment Clause in International Investment Arbitration

Tianshuo Zhang

tianshuo.zhang.22@ucl.ac.uk

University College London, London, UK

Abstract: This article draws on the latest enumerative treaty reform practices of the European Union regarding clauses on fair and equitable treatment, providing a restrictive interpretation of investors' reasonable expectations. It analyzes the constituent elements and exceptional circumstances, aiming to curtail the expansive interpretation by arbitration tribunals. This is done to balance investor rights and host state regulatory sovereignty. Lastly, in response to the latest developments concerning investors' reasonable expectations, the author puts forth effective risk prevention suggestions, considering the distinct perspectives of China as a host country attracting foreign investment and domestic investors engaging in overseas investments.

Key words: Legitimate expectations, Fair and equitable treatment, Restrictive interpretation

1 Introduction

This article aims to explore two issues. First, how to provide a restrictive interpretation of investors’ legitimate expectations in the FET clause, with the aim of better balancing the rights of investors and the regulatory sovereignty of the host State. Second, what effective risk prevention measures, China, as a host State attracting foreign investment and as a home State for outbound investors, can adopt in response to the latest developments regarding investors’ legitimate expectations.

2 Investors’ Legitimate Expectations under Restrictive Interpretation

A significant amount of arbitration practice has affirmed the obligation to protect investors’ legitimate expectations in the FET clause. Therefore, it is unreasonable for arbitral tribunals to deny the existence of investors’ legitimate expectations in the FET clause. However, providing a restrictive interpretation of investors' legitimate expectations in the FET clause would further clarify the elements and applicable standards of investors’ legitimate expectations, which has practical significance [1].

ICEMME 2023, November 17-19, Beijing, People's Republic of China
Copyright © 2024 EAI
DOI 10.4108/eai.17-11-2023.2342659

2.1 The Foundation for The Elements of Investors' Legitimate Expectations

2.1.1 Based on ICSID Arbitration Practice

The identification and summarization of the elements of investor legitimate expectations based on ICSID arbitration practice are characterized by uncertainty. This is because arbitral awards are not binding, and according to Article 53.1 of the Washington Convention, "there is no binding precedent in international investment law". Subsequent tribunals are not obligated to follow previous decisions, and therefore they have valid reasons to refuse the application of constituent elements derived from existing awards. They even have the authority to propose constituent elements standards that are completely opposite to those previously established [2].

2.1.2 Based on The Latest Treaty Practices of The EU

In 2014, the EU signed the Free Trade Agreement with Singapore, and Article 9.4 of the agreement provided a closed list and explicitly included investor legitimate expectations as an independent element under the FET clause [3]. Similarly, in 2017, the EU signed the Comprehensive Economic and Trade Agreement with Canada, and Article 8.10.4 of the agreement also adopted a similar closed list approach [4]. However, the wording was slightly different, as it did not list investor legitimate expectations as an independent element under the FET clause but considered it as a factor. This is an important innovation in the EU's reform of the FET clause since it gains the right to negotiate for international investment agreements from 2009. The closed list approach adopted by the EU is not entirely closed but has a certain flexibility. The implicit mechanism of dynamic adjustment empowers the contracting parties, rather than arbitral tribunals, with the decision-making power to adjust the content of the FET clause [5]. This approach allows for a clear definition of the specific content of the FET clause, thus restricting the discretion of arbitral tribunals, while also providing room for the contracting parties to explore whether other obligations are included under the FET clause, meeting the objectives of investment agreements.

In the latest treaty texts, the EU explicitly and directly defines the meaning of investor legitimate expectations under the FET clause. First, the host State, to attract investment, makes specific or unambiguous representations. Then the investor reasonably relies on these representations and makes an investment based on them. Subsequently, the host State breaches the expectations set by those representations, leading to losses suffered by the investor [6].

2.2 Elements Constituting Legitimate Expectations

2.2.1 The Host State Making Specific Representations

The first constituent element of legitimate expectations for investors is specific representations by the host State, which is also a fundamental requirement of investors' legitimate expectations.

2.2.1.1 Whether the contractual provisions agreed on between the host State and the investor can give rise to investors' legitimate expectations.

A breach of contractual obligations by the host State does not necessarily equate to a breach of treaty obligations [7]. Specifically, if the general breach of contract by the host State is considered within the scope of international law, contractual disputes that could have been resolved under domestic law escalate to international arbitration. This excessively expands the jurisdiction of arbitration tribunals, and also greatly increases the litigation risk for the host State. As a result, investors' legitimate expectations become an umbrella provision. In arbitration practice, the tribunals have made a strict distinction between the expectations arising from contractual provisions with the host State and the investor and the legitimate expectations in international law. In Parkings v. Lithuania, Parkings claimed that the Vilnius municipal government violated its contractual obligations, thereby breaching the investors' legitimate expectations based on the contractual provisions. In response to Parkings' claim, the arbitral tribunal explicitly stated that not all expectations are equivalent to legitimate expectations in international law. Parkings' expectations were contractual in nature and did not constitute legitimate expectations in international law [8].

Therefore, the general contractual provisions agreed on between the host State and the investor do not give rise to legitimate expectations for the investor. The investor's legitimate expectations are from specific representations by the host State. Similarly, in *Parkerings v Lithuania*, the arbitral tribunal also pointed out if the host country explicitly made commitments to investors or provided assurances or statements in an implied manner that could affect their investment decisions, the expectations arising from such commitments relied upon by investors would be considered reasonable [8].

2.2.1.2 Whether the laws and regulations of the host State can give rise to investors' legitimate expectations.

The paper argues that the changes in laws and regulations of the host country do not necessarily give rise to legitimate expectations for investors. Firstly, as norms that regulate social relationships, laws inherently possess the characteristic of continuous development. Therefore, it is not reasonable for investors to expect the laws and regulations of the host State to remain unchanged. Secondly, the modification of a country's own laws and regulations falls within the scope of its sovereignty and should not be easily influenced by the expectations of investors. Lastly, a country's laws and regulations are abstract generalizations of the common aspects of various social relationships, aiming to have a universal binding force on all individuals within its sovereignty. Their inherent generality and abstractness do not provide specific clarity for individual investors [9].

In arbitration practice, there has been a significant contrast in the views of arbitration tribunals regarding this issue in different stages. In the early stages, tribunals emphasized the importance of legal and commercial stability and believed that investors' expectations of legal stability should be protected. However, since 2007, tribunals have taken a markedly different stance, stating that the mere changes in the laws and regulations of the host State do not give rise to legitimate expectations for investors unless there are stabilization clauses or specific commitments by the host State to the investor in the contractual agreement [10].

In conclusion, the basis for the generation of legitimate expectations for investors can be summarized into three categories: specific representations by the host State, contractual provisions agreed upon between the host State and the investor, and the laws and regulations of the host State. However, in arbitration practice, the contractual provisions and laws, and regulations of the host State, that both can give rise to investors' legitimate expectations. The two are essentially specific statements by the host State in the form of contractual provisions or stable clauses in laws and regulations [11]. Ultimately, it is the specific representations by the host State. The scope of specific representations by the host State should not be expanded. This helps to avoid ambiguity, and it facilitates the more accurate application of the concept of legitimate expectations by arbitration tribunals.

2.2.2 Investors'Legitimate Reliance on The Statement and Making Investments

2.2.2.1 Investors' Legitimate Expectations

Subjective legitimacy requires that investors must act in good faith when asserting the protection of their legitimate expectations. If investors intentionally provide false information or conceal substantial information when seeking specific statements from the host State, thereby exhibiting a fraudulent intention towards the host State, their subjective legitimacy will be lost, and legitimate expectations will not arise [12]. In *Thunderbird v Mexico*, the investor obtained a written response from Mexico allowing them to establish gaming machine facilities by falsely claiming that their business did not involve gambling, despite being well aware that local regulations prohibited gambling operations. The manner in which the written response was obtained was itself improper, therefore the expectations based on this written response should not be protected [13].

Objective legitimacy requires that when investors assert the protection of their legitimate expectations, they have already fulfilled the prudent duty expected of a rational investor. A prudent investor should possess the ability to make business judgments and risk management capabilities in cross-border investments. Legitimate expectations of investors are not insurance clauses for their business activities. Investors have an obligation to conduct due diligence on relevant matters regarding investment realization, including but not limited to investigating and analyzing the political, economic, sociocultural, and legal regulatory conditions of the host State. For instance, in *Stadtwerke München and others v Spain*, the arbitral tribunal noted that investors' legitimate expectations must arise from a diligent due diligence process underby the investor [14].

2.2.2.2 Investors Making Investment Decisions Based on Legitimate Expectations

It is important to note the investment behavior referred to here is a concept that evolves over time. Investor investments are realized through multiple stages. Therefore, each phase of investment initiation, expansion, development, or restructuring should be examined for its legitimate expectations [15].

2.2.3 Investors Suffering Losses

The third component of legitimate investor expectations is that investors suffer losses. In other words, in addition to meeting the first two components, investors need to provide evidence of actual losses incurred. Since investors typically assert legitimate expectations to seek compensation from the host State, according to the principle of compensation in civil law, investors bear the burden of proof for the damages they have suffered [16].

In conclusion, based on the explicit listing of elements of legitimate expectations under the latest FET provisions of the EU, it can be analyzed that legitimate expectations consist of three components. Firstly, the host State makes specific statements to attract investments, which must be unambiguous and toward the investors. Secondly, investors reasonably rely on these statements and make investments, meeting both subjective and objective legitimacy. Furthermore, the concept of investment behavior includes subsequent actions throughout the investment process. Thirdly, the host State's breach of these expectations leads to losses suffered by the investors, and the investors need to provide evidence of the specific damages they have incurred [17].

2.3 Exceptions to Legitimate Investor Expectations

After the host State makes specific statements to investors, and the investors reasonably rely on those statements and make investments, there may be substantial changes in the host States' circumstances during the course of the investment operation. To protect public interests, host States breach the initial statement, resulting in losses for the investors. Can public interests serve as an exception clause to legitimate expectations?

2.3.1 Public Interests as An Exception Clause to Legitimate Expectations

In investment arbitration practice, arbitral tribunals have started to consider the host States' public interests as an exception to legitimate expectations. For instance, in *Saluka*, when determining whether the host State has breached the legitimate expectations of investors, it is necessary to take into account situations where the host State exercises its legitimate regulatory powers to protect domestic public interests [18]. In the practice of investment treaty negotiations like The EU and Canada CETA, host States have also begun to incorporate public interests as an exception clause to legitimate expectations and explicitly state them in investment agreements [19].

In conclusion, public interests, as an exception clause for protecting investors' legitimate expectations, have legitimacy. The protection of investors' legitimate expectations should not be excessively expanded or absolutized. By treating the host States' public interests as an exception clause for protecting investors' legitimate expectations, it safeguards the host States' exercise of legitimate sovereign regulatory actions to a certain extent and further promotes a balance between the host States' need for adjusting public policies and the protection of investors' legitimate expectations.

2.3.2 Proportionality Principle in Applying Exception Clauses

When invoking exception clauses, the host State should be restricted to prevent arbitrary applications that could seriously harm the legitimate rights and interests of investors. The proportionality principle should be followed when applying exception clauses. If the actions by the host State to protect public interests are in line with the proportionality principle, such actions can counteract the legitimate expectations of investors. The proportionality principle belongs to the realm of public law and focuses on the value balance between public power and private rights. In international investment, it has certain relevance in balancing the host States' public interests and the private interests of investors [20].

Under the proportionality principle, there are three sub-principles: appropriateness, necessity, and strict proportionality. The appropriateness principle emphasizes the relationship between means and objectives, requiring the host States' measures to have a reasonable connection to its claimed objective of protecting domestic public interests. The necessity principle, also known as the principle of the least restrictive means, requires the host State to choose the least harmful measures to investors to achieve its objective of protecting public interests. In other words, when applying the exceptions clause, arbitration tribunals should determine whether the host State has alternative measures that impose less harm on investors. If such alternatives exist, the host State cannot invoke the exceptions clause. In *CMS v Argentina*, the arbitral tribunal concluded Argentina did indeed undergo a severe economic crisis, but it should have adopted alternative measures causing lesser harm to the investors rather than completely altering the investment environment crucial for the investors' survival. As a result, the host country was ultimately held liable for compensation [21].

3 Suggestions for China of Investors' Legitimate Expectations under Restrictive Interpretation

The concept of investors' legitimate expectations is closely related to the interests between the host State and the investor, and investors frequently invoke their legitimate expectations to claim compensation from the host State. Therefore, analyzing and researching the latest developments in investors' legitimate expectations have significant implications for reducing China's risk as a host State in investment disputes and protecting the legitimate rights and interests of domestic investors in outbound investments [22].

3.1 Suggestions for China as the Host State

3.1.1 Enhancing The Text of Investment Agreements and Establishing Model Clauses for Investor's Legitimate Expectations

Currently, the text of investment agreements concluded by China primarily adopts a traditional approach in formulating the FET clause, stipulating the host States' obligation to provide the FET clause without imposing any conditions. While this approach is advantageous for protecting the interests of investors, it poses risks of expansive interpretations by arbitration tribunals, thereby increasing China's litigation risks as a host State. To restrict the expansive interpretations of investors' legitimate expectations under the FET clause, China, as a contracting party, should enhance the text of investment agreements and establish model clauses for investors' legitimate expectations. This would help to achieve a better balance of interests between the host State and investors [23]. In *CMS v. Argentina*, the arbitration tribunal held Argentina did indeed experience a severe economic crisis, but it should have taken alternative measures that would cause less harm to the investors instead of completely altering the investment environment upon which the investors relied. As a result, the tribunal concluded the host State was liable for compensation [24]. It can be seen that the method by the host State to safeguard public interests should comply with the principle of necessity. Otherwise, the host State may not be able to successfully invoke the exception clause. The narrow proportionality principle, also known as the principle of balance, requires that the harm caused to investors by the method by the host State should be proportionate to the public interests that it seeks to protect. However, the application of the narrow proportionality principle poses certain difficulties for the arbitral tribunal. Unlike the investors' losses, the host country's public interests are more abstract and difficult to quantify in monetary terms. The tribunal needs to consider other value judgments, such as experiential value, in a comprehensive manner [25].

In conclusion, when applying the exception clause, the arbitral tribunal should adhere to the principle of proportionality, which can be analyzed from the perspectives of the suitability principle, necessity principle, and narrow proportionality principle. By doing so, the tribunal can seek the optimal balance between the public interests of the host State and the private interests of the investor.

3.2 Suggestions for Domestic Investors' Outward Investments

When domestic investors engage in overseas investments, they should pay attention to protecting their legitimate rights and interests. If the host State violates their legitimate expectations, investors can proactively invoke the investor's legitimate expectations in the FET clause and initiate arbitration proceedings before an arbitral tribunal. However, investors should not interpret this clause solely based on its literal meaning and blindly assume that all their expectations should be protected. Before making investments, investors should fully understand the elements and exceptions of the investor's legitimate expectations to better utilize this clause to safeguard their own interests [26].

3.2.1 Seeking Specific Commitments from The Host State

When domestic investors engage in foreign investments, they should strive to obtain specific commitments from the host State. Specific commitments from the host State are the basis for the investor's legitimate expectations. If investors wish to invoke their legitimate expectations and initiate arbitration against the host State, they should first obtain specific commitments from the host State [27]. According to arbitration practice, specific commitments by the host State can be categorized into three situations: direct specific commitments by the host State to the investor, obligations related to the exercise of host State sovereignty specified in the investment contract, and stable provisions by the host State to ensure the stability of its legal framework. Before investing, investors should focus on obtaining the above three forms of specific commitments, preferably in written form [28].

4 Conclusion

Restrictive interpretation may be achieved by expressly enumerating the constituent elements of an investor's legitimate expectations in the terms of the investment treaty. The Chinese government, as the host country, could adopt a closed enumeration model for the FET clause in future BIT negotiations. The country also needs to further improve the Foreign Investment Law.

References

[1] Reinisch A. and Schreuer C., 'Fair and Equitable Treatment' International Protection of Investments: The Substantive Standards. Cambridge University Press. p. 253 (2020)
[2] Washington Convention, Article 53.1

[3] EU-Singapore FTA 2014, art 9.4.
[4] EU-Canada CETA 2017, art 8.10.4.
[5] Matos S, Investor Due Diligence and Legitimate Expectations. The Journal of World Investment & Trade. pp 313-314 (2022)
[6] Yulia Levashova, Fair and Equitable Treatment and Investor's Due Diligence Under International Investment Law, Netherlands International Law Review, Vol.67, (2020)
[7] Zhang K, The Development of Fair and Equitable Treatment Clauses in International Investment Agreements and Their Implications for China. Master Thesis of East China University of Political Science and Law (2019)
[8] Parkerings-Compagniet AS v. Republic of Lithuania, ICSID Case No. ARB/05/8, Award.
[9] Wen X: The Application of the Principle of Reasonable Expectation of Investors in International Investment Arbitration Practice. Master's Thesis, East China University of Politics and Law (2020)
[10] Wang X, Innovation of Fair and Equitable Treatment Clause and its Implications for China: A Perspective on the Latest International Investment Agreements of the European Union. China Business Review Journal pp. 2-5. (2018)
[11] El Paso Energy International Company v. The Argentine Republic, ICSID Case No. ARB/03/15, award, 2011, paras.375-377.
[12] Henckels C, Justifying the Protection of Legitimate Expectations in International Investment Law: Legal Certainty and Arbitrary Conduct. ICSID Review -Foreign Investment Law Journal. pp. 1-2. (2023)
[13] *International Thunderbird Gaming Corporation v The United Mexican States*, UNCITRAL, Arbitral Award.
[14] Stadtwerke München GmbH, RWE Innogy GmbH, and others v Kingdom of Spain, ICSID Case No. ARB/15/1, Award of 2 Dec 2019.
[15] Frontier Petroleum Services Ltd. V. The Czech Republic, UNCITRAL, Final Award, para.287.
[16] Antaris Solar GmbH and Dr. Michael Göde v Czech Republic, PCA Case No. 2014-01, Award of 2 May 2018.
[17] Dong J, On the Innovation of the European Union's Fair and Equitable Treatment Provisions for International Investment, Guangxi Social Sciences, (2019)
[18] *Saluka Investments B.V. v. The Czech Republic*, Partial Award, para.304-305
[19] The EU and Canada CETA, art 8.9.
[20] Wongkaew T, Protection of Legitimate Expectations in Investment Treaty Arbitration: A Theory of Detrimental Reliance. CUP. pp. 166-167(2019)
[21] *CMS Gas Transmission Company v. The Republic of Argentina*, Award, para.313-315.
[22] Deng Tingting, Research on Fair and Equitable Treatment in International Investment Agreements, Law Press, 1st edition, pp. 249-252 (2017)
[23] Kong Q and Ding X, Preliminary Interpretation of the Legislative Process and Major Issues of the Foreign Investment Law of the People's Republic of China. International Trade Issue Journal pp. 4-5. (2019)
[24] CMS Gas Transmission Company v. The Republic of Argentina, Award,12 May. 2005, paras. 313-315.
[25] Qin X, On the application of the Principle of Proportionality in Arbitration Cases concerning Fair and Equitable Treatment, Oriental Law, Issue 2 (2021)
[26] Wang X, Innovation of Fair and Equitable Treatment Clause and its Implications for China: A Perspective on the Latest International Investment Agreements of the European Union. China Business Review Journal pp. 2, 5. (2018)

[27] Sanjur A.G. and Khamitova D., Is the concept of legitimate expectations spiraling out of control. British Institute of International and Comparative Law (2022)
[28] Xu Z,'The Issue of Investor Legitimate Expectations in International Investment Arbitration' Master's thesis of Fudan University 1, 15. (2020)