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On the Functional Reinforcement of the Principle of Proportionality to Investors' Legitimate Expectations in International Investment Arbitration

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Abstract

In order to effectively balance the rights of investors with the regulatory sovereignty of host states and provide a more reasonable protection of investors' legitimate expectations, this paper studies the strengthening effect of the proportionality principle in relation to investors' legitimate expectations. By analyzing arbitration cases involving the principle of legitimate expectations, it becomes evident that clarifying the constitutive elements of this principle can to some extent constrain the trend towards expansive interpretations. However, with such clarification, investors' legitimate expectations may still result in an imbalance between the regulatory authority of host states and the economic interests of investors. The proportionality principle has already been employed as an analytical framework for reconciling interests in various investment-related cases concerning legitimate expectations. Through the establishment of a rational framework for balancing interests, the proportionality principle can enhance the functionality of the principle of legitimate expectations, aligning it with the current international investment landscape.

Keywords: international investment arbitration, the principle of proportionality, investor's legitimate expectations, interest balance

1. Introduction

With the deepening of economic globalization and investment liberalization, international investment has continued to grow. Investment relations between developing and developed countries have gradually shifted towards complementarity, and the balance between investors' rights and host country's right to regulate has become a central objective of international investment. In contrast to other stipulations within investment treaties, provisions concerning fair and equitable treatment and indirect expropriation, which exhibit a closer nexus with the principle of investors' legitimate expectations, are more inclined to impinge upon the regulatory authority of the host country. Curbing the trend of expanding the scope of application of investor's reasonable expectations and balancing the interests of host countries and investors have become urgent issues in international investment arbitration. As far as the reasonable expectation of investors is concerned, clarifying its complex components can limit its excessive application, but it cannot make up for the functional defects of its natural favoritism towards investors, which leads to an imbalance of interests. The principle of proportionality, as an important method of balancing the rights of investors and the right of the host country to regulate, has demonstrated its effective role as a rational analytical framework in international investment arbitration. Therefore, based on the international investment arbitration jurisprudence involving investors' reasonable expectations, this paper analyzes the constituent elements of investors' reasonable expectations, discusses the application of the principle of proportionality in the fair and equitable treatment and indirect expropriation clauses, and explores its role in realizing the balance of interests, with a view to providing a path for China to avoid the legal risks brought by the principle of reasonable expectations.

2. The Elements of Legitimate Expectations

In international investment arbitration, the principle of the investor's reasonable expectations has become the preferred means of determining whether an indirect expropriation or a breach of fair and equitable treatment has occurred. [1]In the case of indirect expropriation, reasonable expectation is not an independent factor in the assessment. Some arbitral tribunals have replaced the consideration of objective loss of interest with an analysis of the destruction of the investor's expectation by the host State's conduct in order to demonstrate "expropriation-like effects". In determining whether an expectation has been created, tribunals consider factors such as the political, economic, and legal situation of the host state, but there is no uniform standard. In determining indirect expropriation, the key question is whether the host state's conduct deprived investors of their interests. Reasonable expectation is more of a preliminary issue, and the arbitral tribunal enters into the substantive assessment of the deprivation of property by analyzing whether the investor's reasonable expectation was violated. In the practice of international investment arbitration, reasonable expectation is more related to fair and equitable treatment and becomes one of the elements of the latter's independent obligations. The analysis of proof of reasonable expectation in awards involving fair and equitable treatment is more detailed. Fair and equitable treatment, like indirect expropriation, limits the manner or effect of the host state's conduct to achieve the purpose of limiting the host state's right to regulate reasonably.

Generally speaking, the constituent elements of an investor's reasonable expectation in indirect expropriation and fair and equitable treatment are basically the same, including the basis of the reasonable expectation, the reasonableness of the expectation, the investment decision based on the expectation, the timing of the reasonable expectation, and the loss associated with the failure of the investment. Among them, the basis of the reasonable expectation, the reasonableness of the expectation, and the timing of the reasonable expectation are the focus of the Arbitral Tribunal, which will be analyzed in turn in light of the following case law.

2.1 Basis for Establishing Reasonable Expectations

Indeed, the jurisprudence of international investment tribunals shows that, in the vast majority of cases, reasonable expectations are created by specific, individualized commitments made by States. In the case of El Paso v. Argentine Republic, the tribunal asserted the impossibility of establishing a universally applicable definition for a specific commitment, given its dependence on the prevailing circumstances. Nevertheless, it becomes evident that there exist two discernible categories of obligations that may qualify as 'specific': those characterized by their specificity with regard to subject matter, and those distinguished by their specificity concerning object and purpose. Subsequently, the Antaris v. Czech tribunal proposed a more detailed three-pronged test: "To be considered legitimate, the investor's expectations must be based on assurances (or representations): (i) made by the State to encourage investment; (ii) specifically addressed to the investor; and (iii) sufficiently specific."

As a general rule, general laws cannot be the basis for the creation of reasonable expectations. The final decision in Horthel v. Republic of Poland held that general laws do not create reasonable expectations unless they contain specific promises of stability. The decision in Blusun v. Italian Republic states: "The Court has so far refused to sanctify the law as a promise. There remains a clear distinction between laws, that is to say, norms of a more or less general nature which create rights and obligations while they are in force, and promises or contractual obligations". This does not mean, however, that a general law cannot form the basis of an investor's reasonable expectations. A general law may give rise to a reasonable expectation even if it contains specific promises to the investor, as the tribunal stated in Mobil Exploration v. Argentine Republic: "Even a reasonably general law may be considered a violation of fair and equitable treatment if it violates specific promises made to the investor." Ordinarily, generic regulations are not inherently equipped to encompass precise commitments, primarily due to the inherent uncertainty regarding the likelihood of their subsequent alterations. Nevertheless, contingent upon the specific contextual conditions, the reiteration of a similar category of commitment within an alternative form of general pronouncement may attain the character of a state-specific act, designed with the objective and intention of affording the investor a basis for reasonable reliance. In assessing whether a host state's modification of a general law violates an investor's reasonable expectations, the final decision in Horthel v. Republic of Poland found it important to measure the extent to which the change in the law would have affected specific commitments previously made by the government. In sum, a general law will not normally give rise to an investor's legitimate expectations unless it contains or affects specific commitments made by the host state to the investor.

The award in Ioan Micula v. Romania held that specific representations are not required and that legitimate expectations may arise from acts or conduct of the State; the acts or conduct relied on by the claimant include legislative acts in general or specific acts of the respondent in implementing its tax laws. The tribunal in Infracapital v. Kingdom of Spain suggested that for a warranty or representation to create a legitimate expectation, it is necessary to look at the circumstances surrounding the investment, including the investor's due diligence, as well as the State's past regulatory conduct and judicial decisions, and to analyze the overall regulatory framework and the State's policy interests to determine whether the investor was able to create an expectation.

2.2 Reasonableness of Expectations

The reasonableness of an investor's expectations encompasses both legality and rationality. To begin with, an investor's legitimate expectations should not find their basis in a manner contrary to the general legal framework of the host State. In this regard, the Duke Energy v. Republic of Ecuador tribunal underscored that the evaluation of reasonableness and legitimacy necessitates a comprehensive consideration of the entire spectrum of circumstances. This includes an examination not only of the factual backdrop surrounding the investment but also the political, socio-economic, cultural, and historical conditions prevailing within the host State. Furthermore, the award rendered in BayWa r.e. v. Kingdom of Spain articulated the principle that, in principle, an investor cannot legitimately expect treatment that contravenes the laws of the host State, provided that the host State's laws themselves do not conflict with the treaty under which the tribunal exercises its jurisdiction. The concept of the 'reasonable investor' has been introduced in the arena of international investment arbitration to provide further substantiation for the legitimacy of such expectations. [2] The concept of "reasonable investor" requires the investor to exercise due diligence in making decisions and to make investment decisions prudently and carefully. In MTD v. Republic of Chile, the arbitral tribunal affirmed the investor's duty to ensure that it receives adequate advice, particularly when investing in an unfamiliar foreign environment, and made several references to "due diligence" and the "reasonable investor" when analyzing the damages to be borne by the claimant. The "Reasonable Investor". The concept of the "reasonable investor" helps the tribunal to take a broader view of the investor's situation, to assess the investor's needs more objectively and to avoid excessive subjective expectations on the part of the investor.

2.3 Time of Creation of Reasonable Expectations

Regarding the influence of the timing of an investor's expectations on the formation of reasonable expectations, international investment arbitration awards have established a consistent criterion. This criterion pertains to whether a foreign investor is obligated to base their business decisions and the formulation of their expectations on the legal and factual circumstances prevailing in the host country at the time of the investment. In the Tecmed vs. Mexico case, the tribunal underscored that, in accordance with the principle of good faith enshrined in international law, the fairness clause necessitates Contracting Parties to ensure treatment of international investments that aligns with the fundamental expectations held by foreign investors when initiating their investments. Furthermore, the Frontier vs. Czech Republic tribunal heightened the temporal standard, emphasizing that, if an investment transpires through multiple stages spanning a period of time, the evaluation of reasonable expectations must occur at each juncture where pivotal actions are taken to establish, expand, enhance, or restructure the investment.

Considering the intricate nature of establishing an investor's legitimate expectation, it poses a formidable challenge for arbitral tribunals to exclusively rely on their prior jurisprudence to comprehensively ascertain the presence of a sufficient foundation for creating a legitimate expectation in a given case. Within the realm of international investment arbitration, it is nearly unattainable to encounter two cases where the political, economic, and legal landscape of the host state, the specific conduct of the host state, and the nature of the investor's enterprise are entirely congruent. This complexity is compounded by the fact that arbitral tribunals have reached consensus on only certain facets of the constituent elements of a legitimate expectation while remaining in disagreement on numerous aspects.

In light of such circumstances, even with the guidance of precedent, arbitral tribunals find themselves compelled to conduct a bespoke analysis for each case, evaluating the impact of various objective factors on the investor's legitimate expectations independently. Owing to the inherent divergence in the personal inclinations of arbitrators, variances emerge in the relative weight attributed to these objective factors, thereby resulting in the issuance of inconsistent arbitral awards.

3. Application of the Principle of Proportionality in Reasonable Expectation Arbitration Cases

The principle of proportionality is a method of legal interpretation and decision-making used to deal with conflicting principles and legitimate public policy objectives. The principle of proportionality is capable of reconciling the ends and means of public power and balancing the conflict of different values. [3] Although arbitral tribunals cite jurisprudence in arguing for reasonable expectations in an effort to ensure consistency in their decisions, they still have a large margin of discretion due to the ambiguity of the principle of reasonable expectations itself and the complexity and variability of the facts of the case. Therefore, it is necessary to introduce a new method and standard of review for the principle of proportionality in order to alleviate the problem of inconsistency in arbitral awards and to better balance the property rights and interests of investors with the host state's right to regulate.

3.1 Application of the Principle of Proportionality in Cases Involving Indirect Expropriation

The inaugural application of the proportionality principle within the domain of international investment arbitration unfolded in 2003, within the context of the Tecmed v. Mexico case, where an ICSID tribunal embarked upon an intricate analysis of the concept of indirect expropriation. In this landmark case, the tribunal delineated the investor's purely subjective expectations as safeguarded investments and enunciated a comprehensive assessment framework. This framework was designed to ascertain whether Tecmed had suffered a fundamental deprivation of its economic interest in the investment, thus rendering the Mexican government's decision tantamount to a measure bearing a "similar expropriatory effect" as delineated in Article 5(1) of the Spain-Mexico Bilateral Investment Treaty. The significance of this determination lies in its pivotal role as a principal criterion, within the purview of international tribunals, for distinguishing between a regulatory measure—a situation where the state's exercise of police powers leads to an erosion of assets or rights—and a de facto expropriation, characterized by the complete deprivation of any substantial aspect of said assets and rights. In the quest to ascertain whether the Resolution constituted an expropriation, the Tribunal recognized the imperative need to evaluate whether the measure was proportionate concerning the public policy objectives and the imperative of protecting investments under the prevailing legal framework. Furthermore, the magnitude of the measure's impact emerged as a critical factor in the determination of whether the resolution adhered to the principle of proportionality. This, however, was conducted while respecting the state's exercise of sovereign powers within the framework of law and order, necessitating a judicious balance between the objectives of the measure and the economic rights relinquished, alongside the legitimate expectations of investors.

Through the lens of a proportionality analysis, the tribunal conscientiously considered the societal and public interests safeguarded by the measure, notably the local environment and public health, juxtaposed against the economic repercussions of the measure. Ultimately, the tribunal's verdict rested upon the finding that the Mexican government's decision had indeed engendered a material adverse impact on Tecmed's long-term investment, thereby satisfying the criteria for expropriation as stipulated in the Bilateral Investment Treaty. The proportionality analysis used to find indirect expropriation in Tecmed v. Mexico has been recognized and adopted by arbitral tribunals in many subsequent cases. 2021 Dr. Santiago Torres Bernárdez, the arbitrator in Casinos v. Argentine Republic, has suggested that in distinguishing between compensated indirect expropriation and the exercise of indirect expropriation without compensation, it is important to take into account the extent to which the measure interferes with the protected investment, as well as the reasons and purposes for which the measure was taken. In distinguishing between compensated indirect expropriation and the gratuitous exercise of the host State's police powers or right to regulate, it is important to take into account the extent to which the measure interferes with the protected investment, as well as the reasons and objectives of the host State for the measure in question. At the same time, the impact of the measure on the investment should be proportionate to the interest to be protect.

The analytical approach of the proportionality principle has helped to curb the tendency to over-extend the scope of "indirect expropriation" and to correct the tendency of arbitral tribunals to be overly biased in favor of investor protection. This allows the tribunal to respect the host state's regulatory powers with respect to its domestic economic system while protecting the property rights of investors.

3.2 Application of the Principle of Proportionality in Cases Involving Fair and Equitable Treatment

In the Tecmed v. Mexico case, Tecmed not only contended that the Mexican government's measure constituted an indirect expropriation but also asserted a breach of the fair and equitable treatment provision outlined in Article 4(1) of the Bilateral Investment Treaty between Spain and Mexico. The Tribunal, in its judgment, emphasized that this provision obligates the treaty parties to provide treatment that does not infringe upon the fundamental expectations considered by foreign investors when making their investments. [4] While conducting its comprehensive analysis, the tribunal repeatedly referred to the investor's reasonable expectations. However, it did not categorize these expectations as an autonomous component of the fair and equitable treatment obligation, nor did it employ a proportionality assessment to ascertain whether the host state's measures contravened the principle of proportionality. Since the landmark Saluka case, successive arbitral tribunals have progressively associated fair and equitable treatment with the concepts of reasonableness and proportionality as mechanisms for constraining the extent to which a host state may interfere with foreign investments. Notably, the tribunal in this instance articulated, "No investor can reasonably expect that the circumstances prevailing at the time of the investment will remain exactly the same. To determine whether a foreign investor's expectations have been reasonably frustrated, it is imperative to evaluate the subsequent exercise by the host State of its legitimate right to regulate its domestic affairs in the interest of public welfare." In the adjudication of treaty violations, the tribunal must harmonize the claimant's reasonable expectations with the respondent's prerogative to regulate the economy and employ a proportionality analysis to ascertain whether the actions of the host state infringe upon the tenets of fair and equitable treatment. The analytical framework established by the Saluka tribunal has served as a precedent for subsequent cases, with other tribunals following a similar line of reasoning. In Eureko v. Poland, for instance, the tribunal invoked proportionality to elucidate why the investor's expectations could not be fulfilled. The principle of proportionality has since evolved into one of the fundamental criteria for appraising fair and equitable treatment concerning the reasonable expectations of investors.

In cases where an investor's legitimate expectations form an essential component of the fair and equitable treatment, the principle of proportionality serves as a comprehensive framework for the arbitral tribunal to assess the legitimacy and reasonableness of the host State's exercise of its regulatory authority in the pursuit of public interest, thus achieving a balance among the diverse interests of the involved parties. In contrast to situations involving indirect expropriation, the fair and equitable treatment standard imposes more stringent constraints on the regulatory powers of the host State. Additionally, the reasonable expectations of investors possess clearly defined criteria, necessitating that the conduct of the host State adheres to principles of fairness, impartiality, and reasonableness. The frustration of an investor's reasonable expectations, while not conclusive in establishing a case of indirect expropriation, serves as an independent factor in determining whether a violation of the Fair and Equitable Treatment Clause has occurred. Consequently, the arbitral tribunal is obligated to assess both the timing and the foundation of the investor's reasonable expectations, while also striking a balance between the investor's expectations and the host State's legitimate regulatory authority, with the ultimate goal of realizing fair and equitable treatment.

4. Functional Complement to the Principle of Proportionality to Investors' Reasonable Expectations

Although it is difficult for the principle of investor's reasonable expectation to fully meet the new needs of international investment arbitration in balancing the rights and interests of the host country and the interests of investors, the principle of proportionality has the function of balancing different interests, which can effectively fill the functional deficiencies of investor's reasonable expectation in international investment arbitration and better adapt to the complex and changing international investment environment.

4.1 The Role of the Principle of Proportionality as an Analytical Framework for Balancing Interests

Initially, the principle of proportionality serves as a mechanism to harmonize the interests of both the host State and the investor, thereby providing a structured framework for reconciling these interests with the reasonable expectations of the investor. It is essential to note that the intention behind the principle of proportionality is not to supplant other theoretical approaches, such as the overarching application of general international law principles to treaty interpretation or the reinforcement of investment treaty provisions by customary international law. Instead, the principle of proportionality introduces a novel perspective and analytical method. International investment treaties frequently employ open-ended language to afford investors broad protection of their rights. However, the inherent ambiguity in such clauses leaves significant room for interpretation by arbitral tribunals. Traditional techniques of treaty interpretation have encountered difficulties when grappling with normative issues associated with the interpretation of the fair and equitable treatment standard. Arbitral tribunals have often resorted to precedent in discussing the application of fair and equitable treatment, rather than conducting an autonomous interpretation of the investment treaty itself. This reliance on prior case law results in vague legal reasoning concerning the fair and equitable treatment clause, making it challenging to ensure uniformity in the outcomes of arbitral awards. Furthermore, as arbitral tribunals increasingly focus on safeguarding the economic rights and interests of investors, they may inadvertently downplay the public interest that the host state, in its regulatory role, seeks to protect. This, in turn, leads to a gradual imbalance between the rights of investors and the interests of the host state. To enhance the protection of investors' reasonable expectations, the application of the proportionality principle as an analytical instrument in investment arbitration assumes particular significance. Notably, the principle of proportionality serves a dual role, as it not only informs the application of general fair and equitable treatment provisions but also holds substantial value in investment arbitration cases involving indirect expropriation. Although the status and role of reasonable expectations differ within the contexts of fair and equitable treatment and indirect expropriation, the principle of proportionality equips arbitral tribunals to conduct a more judicious and comprehensive analysis within the legal framework. By striking a balance between the public interest and the reasonable expectations of the investor, this principle ensures that arbitral awards yield reasonable outcomes, recognized as legitimate.

4.2 Proportionality Improves the Reasoning of Arbitral Awards

Through a systematic analysis of the principle of proportionality, arbitral tribunals are able to provide a more rational process for weighing and balancing different interests. Applied as a stable analytical framework in the judging and reasoning process of arbitration, the principle of proportionality helps to determine more accurately and clearly the criteria of fair and equitable treatment by the arbitral tribunal. The application of the principle of proportionality is not a simple mechanical application, but requires a delicate balancing in specific situations. In applying the principle, the arbitral tribunal must take into account the specific circumstances of the investor's reasonable expectations and the relevant national and international law. Such a systematic analysis can better adapt to the characteristics of different cases, cover in the reasoning all factors that may affect the outcome of the award, and ensure the reasonableness and fairness of the award. This helps to eliminate the arbitrators' preference for different interests, thus avoiding the influence of improper factors on the outcome of the award, and thus reducing the excessive restriction on the host country's right to regulate the economy and better reflecting the protection of investors' economic rights and interests.

4.3 The Principle of Proportionality Helps International Investment Law Move away from the Problem of Isolation

The principle of proportionality plays a pivotal role in mitigating the issue of the detachment of international investment law from other international legal frameworks. This detachment has resulted in a proclivity to overlook the comprehensive spectrum of interests in investment arbitration proceedings. The incorporation of the principle of proportionality offers a mechanism for non-investment law principles to permeate the discourse within the realm of investment treaty arbitration. It serves as a means to counteract the fragmentation of international law into distinct functional and interest-driven subsystems, thus facilitating the harmonization and integration of diverse domains within the realm of international law.

In conclusion, the principle of proportionality can complement the function of the investor's reasonable expectations in international investment arbitration. By balancing the rights and interests of the host state and the investor, establishing a reasonable framework for the balancing of interests, and preventing the arbitrator's preference from influencing the outcome of the award, the principle of proportionality makes the principle of investor's reasonable expectations compatible with the current international investment situation. In future practice, the principle of proportionality is expected to become an effective tool to make international investment arbitration more fair, stable and predictable, and to promote the development and improvement of international investment law. However, it is worth noting that the application of the proportionality principle still needs to be further discussed and improved, and at the same time it needs to be combined with other theoretical approaches in order to further enhance the effectiveness and credibility of the international investment arbitration system.

5. Conclusion

The principle of proportionality has been shown to play a role in balancing the standard of review between the public interest of the host state and the private interest of the investor, and can compensate for the functional shortcomings of the principle of reasonable investor expectations. The over-application of the principle of reasonable investor expectations can be effectively curbed by a strict interpretation of what constitutes reasonable investor expectations, as well as by proportionality analysis at the level of appropriateness, necessity, and the narrow principle of proportionality of host state measures. Therefore, in order to comprehensively address the risks posed by investors' reasonable expectations, governments should pay attention to the existence of investors' reasonable expectations when making administrative decisions and make a comprehensive assessment in conjunction with the principle of proportionality. In international investment arbitration cases triggered by investors' reasonable expectations, China should actively apply the principle of proportionality to scientifically explain and justify its own measures. In addition, China can rely on the interpretation and application of the principle of proportionality in investment arbitration jurisprudence, the protective provisions of international investment treaties on the host country's right to regulate, and the professional opinions of experts to win the support of the arbitral tribunal. At the ex-ante level, China can minimize disputes arising from investor expectations by establishing the necessary exception clauses in international investment treaties.

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