



**STATE LIABILITY FOR REGULATORY CHANGES:
NATIONAL LAW AND INVESTMENT LAW PERSPECTIVES**

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INVESTORS V. STATE



WHY IT IS IMPORTANT

- Increased number of investment cases against developed countries and claims targeting State's regulatory decisions made for public purposes (Solar arbitration cases against Spain, Italy, Ispanija, Romania, Bulgaria, The Czech Republic) <http://investmentpolicyhub.unctad.org/Publications/Details/172>
- State regulatory power - one of the main triggers for international investment dispute ISDS reform.
- Many States express worries in respect of the investors' possibility to challenge very sensitive political decisions regarding important reforms for public purpose.
- Anti-ISDS groups: the State must have a right to regulate; it certainly has responsibilities to regulate. The scope of this right is greater in the case of domestic investors than foreign investors protected. It is unfair and limits the regulatory powers of the State.
- New generation of BITs - FTAs: *"Except in rare circumstance, non discriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations."*
- **The EU proposal:** confirming governments' right to set the regulatory provisions; clarifying the concepts of indirect expropriation and fair and equitable treatment; introducing safeguards that would enable governments to keep control over how investment provisions are interpreted. *The European Commission's proposal for an investment court* in Transatlantic Trade and Investment Partnership agreement (TTIP) between the EU and the USA on 16 September 2015, which includes an investment court system meant to replace the existing ISDS mechanism. (http://europa.eu/rapid/press-release_IP-15-5651_lt.htm)

WHEN / ARE STATES LIABLE FOR REGULATORY CHANGE THAT HURTS THE PROFITABILITY OR VALUE OF AN INVESTMENT?

Traditional standpoint point of view:

- under national law State's liability is either impossible or very restricted;
- under investment law - generally accepted under broad and vague concepts of FET or expropriation established in BITS.

Is this legitimate?

Under BITS: requirement of no less protection than for nationals. States cannot discriminate against foreign investors. They must be treated the same as domestic investors.

There is nothing wrong with states giving additional protections to foreign investors compared to domestic investors. That goes to the heart of investor-state treaties. The purpose of the treaty is to attract investment.

Is this true and acceptable?

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INVESTMENT LAW PERSPECTIVE

- To what extent is the investor legitimately entitled to expect that national law is not going to change after it has performed its investment?

BREACH OF FET - DIFFERENT APPROACHES

- With respect to the principle of a stable and predictable legal framework, FET has been associated with an obligation not to frustrate the legitimate expectations of investors.

The **first approach** - based solely on the concept of ensuring a stable legal and business framework.

The **second approach** - more restrictive, requires a specific representation to have been made by the state, including contractual obligations set out in a contract or the existence of a specific commitment between the host state and the investor, or mentioned in a legal measure, before amendment, of the purpose of attracting investment.

The **third approach** (presented in an UNCTAD paper) - makes the legitimate expectation claim subject to further qualifying requirements. This approach requires proof of the following elements to find a breach of legitimate expectations:

- legitimate expectations may arise only from a state's specific representations or commitments to the investor, on which the latter has relied;
- the investor must be aware of the general regulatory environment in the country and expectations must be reasonable, and founded on the political, socioeconomic, cultural and historical conditions prevailing in the state;
- investors' expectations must be balanced against the legitimate regulatory activities of the host country.

PRACTICE OF ARBITRAL TRIBUNALS: BREACH OF FET

First approach: fair and equitable treatment standard entails an element of stability of the regulatory framework. Good governance rule for the State: its administrative, governmental, legislative and judicial system (*Tecmed v Mexico, 2003*).

- Stability of the legal and business framework is . . . an essential element of fair and equitable treatment’ and ‘there is certainly an obligation not to alter the legal and business environment in which the investment has been made’ (*Occidental v Ecuador decision, paras 183, 191*)
- A ‘key element of fair and equitable treatment is the requirement of a “stable framework for the investment”’, along with the requirement to protect legitimate expectations (*Enron v Argentine Republic, ICSID Case No ARB/01/3, Award (22 May 2007) para 260, 262*)
- If the legal framework governing the investment changes in a way that was not anticipated or foreseen by the investor at the time of making the investment, then the investor should be compensated for the cost of complying with those changes. This means that if a new law is adopted, or an existing law is revoked or interpreted or applied in a new way, those changes can trigger state liability (*Tecmed, S.A. v. United Mexican States, ICSID Case No. ARB(AF)/00/2, Award, May 29, 2003, para. 154. Suez and InterAgua v. Argentine Republic, ICSID Case No. ARB/03/17, July 30, 2010, para. 207; Total v. Argentina, ICSID Case No. ARB/04/1, December 27, 2010, para. 122.*)

PRACTICE OF ARBITRAL TRIBUNALS: BREACH OF FET IN EXCEPTIONAL CASES

Second approach: as a matter of principle, the State's right to regulate cannot be considered frozen or restricted as a result of the existence of investment treaties.

Prof. Z. Douglas “[t]he Tecmed ‘standard’ is actually not a standard at all; it 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”.

- No investor may reasonably expect that the circumstances prevailing at the time the investment is made remain totally unchanged. “It is now established in international law that States are not liable to pay compensation to a foreign investor when, in the normal exercise of their regulatory powers, they adopt in a non-discriminatory manner bona fide regulations that are aimed at the general welfare (*Saluka Investments v Czech Republic, 2006, paras 255, 305, 351*).
- It is each State's undeniable right and privilege to exercise its sovereign legislative power. A State has the right to enact, modify or cancel a law at its own discretion. Due diligence is required from the investor, who ‘must anticipate that the circumstances could change, and thus structure its investment in order to adapt it to the potential changes of legal environment.’ (*Parkerings v Lithuania, para 333*).
- Save for the existence of an agreement, in the form of a stabilisation clause or otherwise, there is nothing objectionable about the amendment brought to the regulatory framework existing at the time an investor made its investment. (*Parkerings v Lithuania, para 332*).

BALANCE BETWEEN THE STABILITY AND STATE'S RIGHT TO AMEND THE LAW

Third approach: the crucial question becomes the right balance between the stability and legitimate expectations on the one hand, and the host State's right to amend the regulatory framework on the other. (M. Potestà, *'Legitimate Expectations in Investment Treaty Law: Understanding the Roots and the Limits of a Controversial Concept'* ICSID Review - Foreign Investment Law Journal, Volume 28, Issue 1, 1 May 2013, Pages 88-122)

- Test
- A) An express contractual commitment (preferably in the form of stabilization clause) or a specific unilateral declaration attributable to the State that it would not proceed with changes is needed. Investment treaties do not generally act to freeze the law *unless* those changes are contrary to a specific commitment made by the state (*AES v. Hungary*, ICSID Case No. ARB/07/22, Award, Sept. 23, 2010, para. 9.3.34.)
- B) expectations as to the regulatory framework must be assessed in concreto with regard to all circumstances, including the specificities of the host State, the investor's diligent conduct, State's level of development, as well as the particular sector in which the investment is made.

EXPECTATIONS OF A STABLE FRAMEWORK V SPECIFIC COMMITMENTS

- In the absence of a stabilisation clause or similar commitment, which were not granted in the present case, changes in the regulatory framework would be considered as breaches of the duty to grant full protection and fair and equitable treatment only in case of a **drastic or discriminatory change** in the essential features of the transaction (*Toto v Lebanon, para 244*).
- ‘[T]he 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 (*Impregilo v Argentine Republic, para 291*).
- ‘[T]he record does not show that the State acted **unfairly, unreasonably or inequitably** in the exercise of its legislative power. The Claimant has failed to demonstrate that the modifications of laws were made specifically to prejudice its investment.’ (*Parkerings v Lithuania para 337*).

INDIRECT EXPROPRIATION V. STATE REGULATORY MEASURES

- Expropriation is only legal if it is in the public interest, compliant with due process, nondiscriminatory, and subject to compensation.
- **First approach** - tribunals define illegitimate indirect expropriations only on the basis of a sole-effect doctrine, requiring proof of a 'substantial deprivation' of the right to property (*AES v Hungary, LG&E v Argentina*).
- **Second approach** - tribunals have engaged in a balancing exercise between state interests and impact on investors' rights, taking into account the public purpose of the measure, the bona fide nature of the measure (in terms of transparency, nondiscrimination and non-arbitrariness), and also the proportionality of the measure (*Fireman's Fund Insurance Company v United Mexican States*).

IOAN MICULA, VIOREL MICULA AND OTHERS V. ROMANIA (ICSID CASE NO. ARB/05/20)

- Arbitrators in the case of Ioan Micula, Viorel Micula and others v. Romania have held Romania liable in a December 11, 2013 award to pay upwards of \$250 million US in compensation for breach of the Sweden-Romania bilateral investment treaty.
- The Micula brothers were the majority shareholders of the European Food and Drinks Group (EFDG), a company that owned, in turn, a variety of other companies including the three corporate claimants in their first ICSID case (filed in 2005). After taking advantage of various incentives (the so-called EGO-24 incentives) offered by Romania in the late 1990s, the brothers expanded their operations significantly by developing a highly-integrated food and drinks production business in a disadvantaged area of Romania's Bihor county.
- A majority of the tribunal concluded that Romania **had created a legitimate expectation that the incentives would remain in substantially the same form over a ten year period**. Thus, when Romania later revoked some of the incentives prematurely, in 2005, to appease the European Union and as a prelude to becoming a full-fledged EU member on January 1, 2007, the tribunal majority held that the revocation triggered a breach of the FET obligation.
- **Changes to legal framework should be a) procedurally proper (e.g. in compliance with due process and fair administration and b) substantially proper (e.g. not arbitrary or discriminatory)**.
- In 2014, the Commission enjoined Romania from paying the award, pending a formal investigation into whether payment of the award would amount to the granting of a new form of illegal "state aid" to the Miculas. Subsequently, the Commission determined that compensation to the Miculas would put Romania in breach of EU state aid rules. This holding has put Romania in the awkward situation of being in breach of its BIT obligations, and yet operating under threat of EU retaliation if it honours the arbitral award.
- On 26 February, 2016 ICSID annulment committee has rejected a bid by Romania to annul a controversial December 2013 arbitral award.

NEW CHALLENGES - SOLAR ARBITRATION CASES AGAINST SPAIN

- *Charanne* (Stockholm Chamber of Commerce, January 2016); *Isolux* (Stockholm Chamber of Commerce, July 2016); and *Eiser* (ICSID, May 2)
- *Charanne* (Stockholm Chamber of Commerce, January 2016)
- The claimants' expectations were **not grounded in specific contracts** signed with the state. A reasonable sophisticated investor doing **due diligence** prior to making its investment should have foreseen the possibility of future adverse regulatory change. It had **not effected a substantial deprivation** of the claimant's shareholdings in their Spanish plant.
- *Electrabel v. Hungary* „it is well established that the host state is entitled to maintain a reasonable degree of regulatory flexibility to respond to changing circumstances in the public interest“.
- *Separate opinion* - Legitimate expectations can arise **even where there has been no specific commitment** (for e.g. as in a contract with an investor). Thus, legitimate expectations might derive from a broader legal framework in a situation where certain incentives or benefits are offered **to a specific category of persons** (rather than the general population)

ISOLUX (STOCKHOLM CHAMBER OF COMMERCE, JULY 2016)

- The tribunal concluded that the claimant could not have had a legitimate expectation at the time of its investment that the regulatory framework would not materially - or even fundamentally - change, since
 - (i) in the years prior to the investment, the regulatory framework had already been modified on various occasions (paragraph 788),
 - (ii) the Spanish Supreme Court had established clearly that - insofar as national law was concerned - there were no obstacles to the modification of the regulatory regime, with a reasonable investor presumed to have knowledge of this situation (paragraphs 793-794); and
 - (iii) the claimant was perfectly aware of the referenced Spanish case law (paragraph 795).

EISER INFRASTRUCTURE LIMITED AND ENERGIA SOLAR LUXEMBOURG SARL V SPAIN

- The Tribunal awarded damages of € 128 million plus interest to investors Eiser and its subsidiary for loss in value of their investments in three concentrated solar power (CSP) thermosolar plants.
- Recognizing the inherent right of states to regulate, and thus rejecting any suggestion of an absolute right to regulatory stability, the Tribunal concluded that the FET clause of the ECT protected against “*fundamental*” changes in a manner that failed to take account of the circumstances of existing investments made in reliance on the prior regime and that led to “*unprecedented*”, “*totally different*” regulatory regimes.
- The Tribunal distinguished the case from the Charanne award affirming that the factual and legal situations in the two cases were “*fundamentally different*,” the measures challenged in Charanne having only marginally decreased solar investments’ profitability, being “*much less dramatic*” and “*much less extensive*” than those challenged in Eiser, which created “*a totally new regulatory focus*,” and were applied in a manner which “*eliminated the financial bases*” of existing investments.
- More: <https://efilablog.org/2017/05/19/before-the-other-shoe-drops-ii-the-first-icsid-final-award-in-the-spanish-renewable-energy-arbitration-saga-finds-for-the-investors-crossing-the-line/> and <https://www.italaw.com/cases/5721>

“TOTAL AND UNREASONABLE” CHANGE IN THE REGULATORY REGIME WAS THE VIRTUAL DESTRUCTION OF INVESTMENT

- 363. “...[T]he Tribunal finds that Respondent’s obligation under the ECT to provide fair and equitable treatment to investors protects them from a fundamental change in the regulatory regime in a manner which does not take into account the circumstances of the existing investment made on the basis of the prior regime. The ECT does not prohibit Spain from making appropriate changes in the regulatory regime of RD 661/2007....But the ECT does protect investors against the total and unreasonable changes experienced here.”
- 352. “Taking into account the context, object and aim of the ECT, the Tribunal concludes that the obligation to provide fair and equitable treatment established by Article 10(1) necessarily implies an obligation to provide fundamental stability in the essential characteristics of the legal regime on which investors relied in making long-term investments. This does not mean that regulatory regimes cannot evolve. Clearly they can....[but] they may not be so radically changed that they deny investors who made investments on the basis of such regimes of the value of their investment.”

EISER INFRASTRUCTURE LIMITED AND ENERGIA SOLAR LUXEMBOURG SARL V ISPANIJA BYLA

- 387. “Claimants could not reasonably expect that there would be no change in the regime of RD 661/2007 over the course of three or four decades. As with any other regulated investment, they must have anticipated that there would be changes over time. Nonetheless, Article 10(1) of the ECT gave them the right to expect that Spain would not modify, in a drastic and abrupt manner, the regime on which their investment depended, in a manner which destroyed its value. But this was the resultAs expressed in Parkerings: ‘any businessman or investor knows that laws will evolve over time. What is prohibited, however, is for the State to act unfairly, unreasonably or inequitably in the exercise of its legislative power.’”
- 418. “...The derogation of RD 661/2007 by Respondent, and its decision to apply a completely new method to reduce the remuneration of Claimants’ existing plants, denied them of essentially the entire value of their investment. Doing so violated Respondent’s obligation to provide fair and equitable treatment.”
- 458. “The Tribunal considers that Respondent ‘crossed the line’ and violated the obligation to provide fair and equitable treatment in June 2014 when the prior regulatory regime was definitively replaced by a completely new regime....”

BLUSUN S.A., JEAN-PIERRE LECORCIER AND MICHAEL STEIN V. ITALIAN REPUBLIC (ICSID CASE NO. ARB/14/3)

- “In the absence of a specific commitment, the state has no obligation to grant subsidies such as feed-in tariffs, or to maintain them unchanged once granted. But if they are lawfully granted, and if it becomes necessary to modify them, this should be done in a manner which is not disproportionate to the aim of the legislative amendment, and should have due regard to the reasonable reliance interests of recipients who may have committed substantial resources on the basis of the earlier regime.” (Award, para. 319(5)).
- It is not for an investment tribunal to decide, contrary to the considered view of those authorities, the content of the public interest of their state, nor to weigh against it the largely incommensurable public interest of the capital exporting state. The criterion of ‘unreasonableness’ can be criticized on similar grounds, as an open-ended mandate to second-guess the host state’s policies. By contrast, **disproportionality** carries in-built limitations and is more determinate. It is a criterion which administrative law courts, and human rights courts, have become accustomed to apply to governmental action.” (Award, para. 318)
- <http://kluwarbitrationblog.com/2017/08/18/legitimate-expectations-absence-specific-commitments-according-findings-blusun-v-italy-inconsistency-among-tribunals-solar-energy-cases/>

LEGITIMATE EXPECTATIONS IN THE ABSENCE OF SPECIFIC COMMITMENTS: CONCLUSIONS

- “[A]bsent explicit undertakings directly extended to investors and guaranteeing that States will not change their laws or regulations, investment treaties do not eliminate States’ right to modify their regulatory regimes to meet evolving circumstances **and public needs...**” (emphasis added) (*Eiser v. Spain Award, para. 362*).
- The investors’ legitimate expectations can nonetheless be frustrated by modifications of the existing regulatory framework provided that, in enacting such modifications, the State acted **unreasonably, disproportionately or contrary to the public interest.**
- As to the proportionality, the changes would not be proportionate if they are **capricious or unnecessary and amount to sudden and unpredictable elimination** of the essential characteristics of the existing regulation.

NATIONAL PERSPECTIVE: PROCEDURAL AND SUBSTANTIAL DIFFICULTIES I

Procedural difficulties: challenge of regulatory measures only by Constitutional court; immunity of legislator from liability; doctrine of separation of powers limiting judicial control

Substantial difficulties in establishing liability for legislative omission and/or for legislative act for public good:

- General rules of non-contractual (delictual) liability: difficulties to establish fault and unlawful conduct; wide margin of appreciation of legislator.
- Exceptional rules of liability for lawful conduct: prohibition of expropriation governed by property or Constitutional law, limited concept of property, no specific regulation.

NATIONAL PERSPECTIVE: PROCEDURAL AND SUBSTANTIAL DIFFICULTIES II

- Developments triggered by practice of European Court of Justice and European Court of Human Rights: State liability is widely recognized for regulatory measures in breach of EU law, international law or human rights.
- **Germany:** concept of liability arising from an expropriation like intervention (enteignungsgleicher Eingriff). The claim may be based on infringement of a property rights, resulting in specific sacrifice for the general public benefit that others do not have to bear. Property may include the right to an established and ongoing business and encompass the business current assets but not its uncertain future profits.
- Under ‘Sonderopfertheorie’ of German law individuals who, by reason of lawful public action, suffer a ‘special sacrifice’, that is to say damage equivalent to expropriation, must be granted reparation.
- **France:** concept of unequal discharge of public burden (rupture de l'égalité devant les charges publiques) (followed by Belgium, Netherlands, etc.). The State is liable of abnormal and special loss of the victim. In Belgium liability is possible for faulty behaviour if legislator did not acted as reasonable legislator. Netherlands - possibility to claim damages for disproportionately suffered disadvantage.
- **Spanish law** goes even further placing liability for normal operating of public services on an equal footing in the governing legislation with liability for abnormal operation
- **More: The Liability of Public Authorities in Comparative Perspective. ed. / Ken Oliphant. 1. ed. Cambridge : Intersentia, 2016**

REGIONAL PERSPECTIVE

- EU law
- A) Liability for breach of EU law by Member States - possible after Francovich case in 1991 (C-6/90, C-9/90 Francovich v. Italian Republic [1991] ECR-5357), Brasserie du Pêcheur/Factortame case (C-46/93, C-48/93 Pêcheur v Gerany [1996] ECR I-1029)
- B) Liability for lawful conduct of EU as legislator - very exceptional after FIAMM case (C-121/06 FIAMM v. Council and Commission [2008] ECR I-6513). Formal argument - Member States legal systems does not allow for acceptance of the idea that such liability belongs to the general principle common to the laws of the Member States.
- The only way is situation where restrictions of the right to property and the freedom to pursue a trade or profession that impair the very substance of those rights in a disproportionate and intolerable manner (because no provision has been made for compensation), could give rise to non-contractual liability. (Gutman case 2011).
- RECOMMENDATION No. R (84) 15 OF THE COMMITTEE OF MINISTERS TO MEMBER STATES RELATING TO PUBLIC LIABILITY 1984: “Reparation should be ensured if it would be manifestly unjust to allow the injured person alone to bear the damage, having regard to the following circumstances: the act is in the general interest, only one person or a limited number of persons have suffered the damage and the act was exceptional or the damage was an exceptional result of the act.”

VATTENFALL V. GERMANY CASE (JUDGMENT OF 06 DECEMBER 2016 1 BVR 2821/11, 1 BVR 1456/12, 1 BVR 321/12)

- *Vattenfall* dispute relates to the sudden decision of the German Government following the Fukushima disaster to close down all nuclear power stations without any compensation. This decision was taken only months after the same Government had decided to significantly extend the periods of the existing permits for the nuclear power plants.
- The main question at issue in the ECT proceedings and before GCC is very similar: **must Germany compensate Vattenfall according to the ECT because the investments (property) of Vattenfall were unjustifiably expropriated?**
- The GCC unambiguously confirmed the broad regulatory powers of the State.
- Despite the broad regulatory freedom of the State, the State must act within certain boundaries.
- Even the paramount public interest grounds for an accelerated nuclear phase-out **cannot absolve** the legislature of the consequences of those investments undertaken in the short period of validity of the 11th AtG Amendment [which extended the permissions] and **in the legitimate expectation** that the legislature itself had brought about with view of the prolongation of the operational lifetimes.
- Based on the principle of proportionality the GCC found that the **lack of any compensation** for the complete reversal of its policy on nuclear power **constitutes violation of the property rights** of Vattenfall.
- <http://kluwarbitrationblog.com/2016/12/29/german-constitutional-court-judgment-vattenfall-case-lessons-ect-vattenfall-arbitral-tribunal/>
- <https://energytransition.org/2016/12/german-constitutional-court-merkels-phaseout-legal-for-the-most-part/>

CONCLUSIONS: ARE DIFFERENCES SO OBVIOUS?

- No general threshold / formula applicable in all types of situations neither in national nor investment law.
- Both national and investment law systems are cautious - recognizing each State's undeniable right and privilege to exercise its sovereign legislative power. A State has the right to enact, modify or cancel a law at its own discretion.
- Balancing test for application of liability is usually applicable and consists of number of factors that should be taken into consideration, evaluation of all factual circumstances of situation is needed.
- No much difference in the outcome of different cases.