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MEMORANDUM

FR: Lori Wallach, Global Trade Watch
DT: September 5, 2012
RE: **"Fair and Equitable Treatment" and Investors' Reasonable Expectations: Rulings in U.S. FTAs & BITs Demonstrate FET Definition Must be Narrowed**

The most successful (and controversial) basis for investors' challenges of government measures under U.S. trade and investment agreements is alleged violations of "fair and equitable treatment" (FET). Fully 74 percent of "successful" investor claims under U.S. Free Trade Agreements (FTAs) and Bilateral Investment Treaties (BITs) –17 awards—have found FET violations.

This note summarizes a review of the known investor-state rulings under U.S. FTAs and BITs. Our goal was to consider if actual tribunal decisions concerning the Minimum Standard of Treatment (MST) and FET standards supported the claims by the Office of the U.S. Trade Representative (USTR) that the language in past U.S. FTAs and BITs does not subject countries to claims under these obligations if, for instance, countries simply alter their policies. This is a critical question. No country wants to have its normal functions circumscribed by the threat of having to compensate foreign investors simply because a government alters a policy to respond to changing circumstances, such as financial crises or new scientific findings relating to the environment or health, or to respond to public demands that lead to the democratic creation of new laws of general application.

USTR argues that the FET standard only provides for compensation for denials of justice as that term has long been understood under customary international law (CIL) - denial of due process in court or administrative proceedings or denial of police protection. To bolster the argument that the current FET and MST language is not problematic, USTR points to an Annex included in U.S. FTAs since the Central America Free Trade Agreement (CAFTA), which is included in the draft Trans-Pacific Partnership (TPP) investment chapter as Annex 12-B. The Annex states that the MST and FET standards are rooted in CIL understandings of the relevant terms. USTR argues that this remedied the problem of runaway tribunals generating fanciful notions of investor expectations and imposing new obligations on states. Thus, USTR argues that no further definition or limitation of the standards, nor exceptions to the TPP's investment chapter, are needed.

The June 29, 2012 investor-state ruling on the merits in the CAFTA *Railroad Development Corporation* (RDC) case confirmed that in fact the Annex is insufficient. The tribunal explicitly rejected arguments raised by Guatemala, the United States, El Salvador and Honduras that the tribunal must base its MST analysis on actual state practice. Instead, the tribunal relied on a definition issued by a tribunal in the North American Free Trade Agreement (NAFTA) *Waste Management II* award to find against Guatemala.[1]

Our review shows that investment tribunals interpret FET in U.S. FTAs and BITs more broadly than the standard of protection under customary international law.

This review demonstrates that arbitral tribunals applying the U.S. FTA and BIT MST and FET language have used enormous discretion to stretch the MST and FET obligations far beyond those limited grounds. As we describe in our July 2012 memo on the CAFTA *RDC v. Guatemala* analysis, such expansive discretion remains even after inclusion of the standard U.S. FTA CIL MST Annex.[2]

Indeed, this elasticity has become a worrying trend *throughout* the body of investor-state dispute resolution (ISDR) awards. As Georgetown University Law Professor Matt Porterfield has written[3]:

> Despite efforts to limit the standard for fair and equitable treatment (FET) by linking it to customary international law (CIL), investors and investment tribunals continue to interpret FET to impose broad limits on government authority. Accordingly, the text of the Trans-Pacific Partnership Agreement (TPPA) should define FET as limited to the narrow set of rights that have been established through state practice as CIL. In addition, the TPPA's text should clarify that an investor who asserts that a new rule of CIL has developed has the burden of demonstrating that the rule exists based on actual state practice.
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> The right to FET has become the most frequently invoked and controversial right granted to foreign investors under investment treaties (including both bilateral investment treaties and the investment chapters of free trade agreements). FET provisions have been interpreted broadly to include a right to a "stable and predictable regulatory environment." This interpretation has been used successfully to challenge changes in regulatory or tax policy.[4] Investors have also used FET to assert rights under trade agreements. Philip Morris, for example, is using the Hong Kong – Australia Bilateral Investment Treaty to argue that Australia's plain packaging law for cigarettes violates FET by "contraven[ing] Australia's international obligations under the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS) . . . and the Agreement on Technical Barriers to Trade (TBT)."[5]
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> Several countries involved in the TPPA negotiations have previously attempted to constrain broad interpretations of FET by linking it to the standard of protection under CIL.[6] In theory, CIL is based on the "general and consistent practice of States" that they follow out of a sense of legal obligation (*opinio juris*). A FET standard based on actual state practice is unlikely to be controversial given that it would not exceed the level of protection for foreign investors that states have generally and consistently provided.
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> In practice, however, arbitrators rarely examine actual state practice. Instead, they simply cite the awards of other tribunals[7] or the text of other investment treaties[8] in support of broad interpretations of FET, including the "right to a stable and predictable regulatory environment." Arbitrators resist pressure to interpret FET based on actual state practice. One prominent arbitrator has gone so far as to suggest that the traditional definition of CIL is "wrong" to the extent that it does not accept the text of investment treaties as state practice.[9] Accordingly, the TPPA should clarify that FET is limited to the traditional standard under CIL in order to prevent arbitrators from creating expansive new rights for foreign investors.

The improvement Professor Porterfield recommends is required to ensure that governments are not held to violate these standards merely by altering domestic laws or establishing new policies that apply generally to domestic and foreign firms. Further, to foreclose the ability for investors to use the broader, vaguer FET standards of past agreements via the Most Favored Nation (MFN) clause, language must be added to the TPP investment chapter specifying that only the TPP MST and FET

standards shall apply with respect to disputes between investors of the TPP signatory countries and those governments.[10]

FINDINGS: Of the 23 known (published) "wins" by investors under U.S. trade and investment agreements, nearly 75 percent (17) have found MST/FET violations. By contrast, only six have found national treatment violations, three have found expropriation violations, and three have found performance requirement violations. (Some cases found violations of multiple standards.) MST/FET claims also yield by far the highest "success" rate of all possible claims in these cases; tribunals have agreed with investors in 81 percent of the instances that MST/FET violations are alleged among published investor "wins."

While some violations have been found by cause of "denial of justice" as that term has long been understood under customary international law, some arbitral tribunals have been willing to find FET violations for regulatory actions that the investor claims violated their "reasonable expectations".

For instance, the tribunal in the *El Paso v. Argentina* case noted that some tribunals had adopted particularly extreme interpretations of FET:

> "Sometimes, the description of what FET implies looks like a programme of good governance that no State in the world is capable of guaranteeing at all times. The exigencies of FET have been detailed in *Tecmed* in the following manner:
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> > 'To provide to international investments treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment. The foreign investor expects the host State to act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor, so that it may know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives, to be able to plan its investment and comply with such regulations. Any and all State actions conforming to such criteria should relate not only to the guidelines, directives or requirements issued, or the resolutions approved thereunder, but also to the goals underlying such regulations. The foreign investor also expects the host State to act consistently, i.e. without arbitrarily revoking any preexisting decisions or permits issued by the state that were relied upon by the investor to assume its commitments as well as to plan and launch its commercial and business activities. The investor also expects the state to use the legal instruments that govern the actions of the investor or the investment in conformity with the function usually assigned to such instruments, and not to deprive the investor of its investment without the required compensation.'…"

Another only slightly less far-reaching conception implies that the state is under an obligation to stabilize the legal and business framework in which the foreign investment was made. For example, in the 2004 award in the case of *Occidental Exploration and Production Co. v. Ecuador* concerning value added taxes, the tribunal stated:

> "Although fair and equitable treatment is not defined in the Treaty, the Preamble clearly records the agreement of the parties that such treatment 'is desirable in order to maintain a stable framework for investment and maximum effective utilization of economic resources.' The stability of the legal and business framework is thus an essential element of fair and equitable treatment."

The Tribunal further stressed this point by saying that "there is certainly an obligation not to alter the legal and business environment in which the investment has been made."

While the *El Paso* tribunal distanced itself from these findings, it nonetheless wrote that: "…the Tribunal considers that a violation can be found even if there is a mere objective disregard of the rights enjoyed by the investor under the FET standard, and that such a violation does not require subjective bad faith on the part of the State." This approach of the Tribunal has been followed in several earlier arbitral awards.

For instance, in *Loewen v. United States*, the tribunal clearly explained this point:

> "Neither State practice, the decisions of international tribunals nor the opinion of commentators support the view that bad faith or malicious intention is an essential element of unfair and inequitable treatment or denial of justice amounting to a breach of international justice. Manifest injustice in the sense of a lack of due process leading to an outcome which offends a sense of judicial propriety is enough, even if one applies the interpretation according to its terms."

Likewise, in *CMS v. Argentina*, the tribunal said:

> "The Tribunal believes this is an objective requirement unrelated to whether the Respondent has had any deliberate intention or bad faith in adopting the measures in question. Of course, such intention and bad faith can aggravate the situation but are not an essential element of the standard."

This analysis was also followed in *LG&E v. Argentina*, where the tribunal declared that it was "not convinced that bad faith or something comparable would ever be necessary to find a violation of fair and equitable treatment."

The *El Paso* panel went on to elaborate its own method:

> "A reasonable general regulation can be considered a violation of the FET standard if it violates a specific commitment towards the investor. The Tribunal considers that a special commitment by the State towards an investor provides the latter with a certain protection against changes in the legislation, but it needs to discuss more thoroughly the concept of "specific commitments." In the Tribunal's view, no general definition of what constitutes a specific commitment can be given, as all depends on the circumstances. However, it seems that two types of commitments might be considered "specific": those specific as to their addressee and those specific regarding their object and purpose.
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> 376. First, in order to prevent a change in regulations being applied to an investor or certain behaviour of the State, there can indeed exist specific commitments directly made to the investor – for example in a contract or in a letter of intent, or even through a specific promise in a person-to-person business meeting – and not simply general statements in treaties or legislation which, because of their nature of general regulations, can evolve. The important aspect of the commitment is not so much that it is legally binding – which usually gives rise to some sort of responsibility if it is violated without a need to refer to FET – but that it contains a specific commitment directly made to the investor, on which the latter has relied.

> 377. Second, a commitment can be considered specific if its *precise object was to give a real guarantee of stability to the investor*. Usually general texts cannot contain such commitments, as there is no guarantee that they will not be modified in due course. However, a reiteration of the same type of commitment in different types of general statements could, considering the circumstances, amount to a specific behaviour of the State, the object and purpose of which is to give the investor a guarantee on which it can justifiably rely.
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> 378. The tribunal in *Continental* addressed the question of what can be considered a special commitment giving "reasonable legitimate expectations" to the foreign investor with care and insight. It insisted on 'the specificity of the undertaking' that can give rise to reasonable legal expectations, and for that purpose distinguished:
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> - Political statements which can – 'regrettably but notoriously' says the tribunal – create no legal expectations;
> - general legislative statements which 'engender reduced expectations;'
> - contractual undertakings by governments which can create more legitimate expectations and 'deserve clearly more scrutiny,' as 'they generate as a rule legal rights and therefore expectations of compliance.' But even there, the tribunal says, whether the FET standard has been violated will depend on 'the context, reasons and effect' of the unilateral modification."

(See the full text of the ruling here:
http://italaw.com/documents/El_Paso_v._Argentina_Award_ENG.pdf)

Most recently, the June 2012 *RDC v. Guatemala* award shows that even with the inclusion of the standard U.S. FTA CIL MST Annex, tribunals can continue with elastic interpretations that extend beyond state practice. Via non-disputing party submissions, the United States, El Salvador, and Honduras joined Guatemala in arguing that the MST obligation to comply with CIL should be interpreted as the law practiced by "states themselves," rather than being based on the pronouncements of other investor-state tribunals.[11] The tribunal *explicitly* declined to limit its consideration to state practice.

Instead, taking the view that MST is an ever-evolving standard, the tribunal borrowed an interpretation from the NAFTA investor-state *Waste Management II* award, which established its own test:

> "… the minimum standard of treatment of fair and equitable treatment is infringed by conduct attributable to the State and harmful to the claimant if the conduct is arbitrary, grossly unfair, unjust, idiosyncratic, is discriminatory and exposes the claimant to sectional or racial prejudice, or involves a lack of due process leading to an outcome which offends judicial propriety – as might be the case with a manifest failure of natural justice in judicial proceedings or a complete lack of transparency and candor in an administrative process."

The award then noted: "In applying this standard it is relevant that the treatment is in breach of representations made by the host State which were reasonably relied on by the claimant."[12]

The tribunal also suggested that the actual state parties to CAFTA misunderstood the pact's MST requirements and also CIL.[13] The panel also took a rather disparaging view of the oft-cited 1926 *Neer* case that the United States, El Salvador, and Honduras referenced as establishing the state practice concept in CIL.[14]

In dismissing the CAFTA signatory countries' arguments that the MST standard evolves only as does actual state practice, the panel noted that the governments' own citations to NAFTA and CAFTA case law demonstrated that arbitral decisions contribute to the understanding of international investor rights.[15] The tribunal also explained its reliance on past tribunals' rulings in NAFTA investor-state cases by noting that the definition of investors' MST rights are "constantly in a process of development."[16] Proceeding with this elastic interpretation, the tribunal declared that the Guatemalan government's *lesivo* declaration fell into the MST definition of "arbitrary, grossly unfair, [and] unjust" generated by the tribunal in *Waste Management II.*[17]

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As the above analysis shows, contrary to USTR claims that the current language provides only limited exposure for States, this is not the actual outcome in tribunal rulings interpreting the relevant language. Changes to the past formulation are required to stop investors from being able to obtain compensation from governments for alleged FET violations derived from upsetting of "investor expectations" – a wildly elastic and subjective notion.

The FET standard needs to be more narrowly and specifically defined in the TPP. Specifically, tribunals' discretion to impute "investor expectations" into the standard must be foreclosed. Investor claims of FET violations cannot be based on politicians' statements or legislative enactments of general application, which can and do change regularly as part of legitimate government actions to address new circumstances or demands. Likewise, FET must be defined to refer to something more than mere contract violations, for which other remedies are available. In sum, the TPP FET definition must be narrowed so that governments can change regulatory regimes without being found guilty of FET violations.

The TPP can rein in runaway FET findings if the definition is narrowed and a clause added to make clear that investors cannot use the MFN clause to read-in past vague definitions. Worryingly, there are few brackets in the MST text of the leaked TPP investment chapter. This is language that requires redesign.

ENDNOTES

[1] *Railroad Development Corporation (RDC) v. Republic of Guatemala*, ICSID Case No. ARB/07/23, Award (June 29, 2012). (Hereinafter "RDC v. Guatemala".)

[2] Lori Wallach and Ben Beachy, "NAFTA Investor-State Ruling: Annex on Minimum Standard of Treatment, Proposed for TPP, Proves Insufficient as Tribunal Ignores Customary International Law Standard, Applies MST Definition from Past NAFTA Award to Rule against Guatemala", Public Citizen's Global Trade Watch July 19, 2012.

[3] Matthew Porterfield, "The Standard for "Fair and Equitable Treatment" Should be Clarified in the Investment Chapter of the TPPA" Georgetown University Law School, *Feb. 28, 2012*

[4] *See, e.g.*, LG&E Energy Corp. v. Argentine Republic, ICSID Case No. ARB/02/1, Decision on Liability, para. 131 (Oct. 3, 2006) (changes in laws governing rates charged for gas held to violate investor's right under FET to "a stable and predictable legal framework necessary to fulfill the justified expectations of the foreign investor.") *See generally* Matthew C. Porterfield, *State Practice and the (Purported) Obligation Under Customary International Law to Provide Compensation for Regulatory Expropriations***,** 37 North Carolina J. Int'l L. & Com. Reg. 159, 166-171 (2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1969838 .

[5] Notice of Claim, Philip Morris Asia Ltd. v. Commonwealth of Australia, para. 10(b) (June 22, 2011), *available at* http://www.ag.gov.au/Internationallaw/Pages/Investor-State-Arbitration---Tobacco-Plain-Packaging.aspx; *see also Request for Arbitration, FTR Holdings S.A. v. Oriental Republic of Uruguay*, paras. 84-85, ICSID case no. ARB/10/7 (March 26, 2010) (Uruguay's tobacco labeling laws "must also be considered unfair and inequitable because they are incompatible,

inter alia, with Uruguay's treaty obligation under . . . [TRIPS]"); *available at* http://www.smoke-free.ca/eng_home/2010/PMIvsUruguay/PMI-Uruguay%20complaint0001.pdf.

[6] S*ee, e.g.*, Agreement Establishing the ASEAN-Australia-New Zealand Free Trade Area, ch. 11, art. 6(2)(c), Feb. 27, 2009, *available at* http://www.dfat.gov.au/fta/aanzfta/chapters/chapter11.html#fr6 ("[T]he concepts of 'fair and equitable treatment' and 'full protection and security' do not require treatment in addition to or beyond that which is required under customary international law, and do not create additional substantive rights."); U.S. Model Bilateral Investment Treaty, art. 5.2, 2004, *available at* http://www.ustr.gov/sites/default/files/U.S.%20model%20BIT.pdf ("The concept… of 'fair and equitable treatment' . . . do[es] not require treatment in addition to or beyond that which is required by [customary international law], and do[es] not create additional substantive rights").

[7] *See* Moshe Hirsch, *Sources of International Investment Law* at 27 (International Law Association Study Group on the Role of Soft Law Instruments in International Investment Law, Working Paper No. 05-11, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1892564 ("An examination of decisions rendered by investment tribunals indicates that investment tribunals that pronounce various customary rules are inclined *not* to discuss the existence (or lack of) of the separate components of 'practice' and '*opinion juris'*, and that they frequently rely on decisions of international courts and tribunals . . . ."); Stephan W. Schill, *From Sources to Discourse: Investment Treaty Jurisprudence as the New Custom?* at 2 (2011) ("Investment treaty tribunals . . . generate and implement a multilateral structure for international investment relations . . . not by reference to customary international law, but by referencing their own jurisprudence.")

[8] S*ee* Charles H. Brower, II, *Why the FTC Notes of Interpretation Constitute a Partial Amendment of NAFTA Article 1105*, 46 VA. J. INT'L L. 347, 358 **(**2006) ("[T]o the extent that treaties codify existing custom, their content should influence the application of [FET provisions] . . . . Alternatively, the widespread adoption of multilateral or bilateral treaties may reflect state practice sufficient to influence the development of custom . . . .")

[9] Andreas Lowenfeld, *Investment Agreements and International Law*, 42 COLUM. J. TRANSNAT'L L. 123, 130 (2003).

[10] This could be accomplished by adding language to the TPP Exceptions Chapter specifying something to the effect of: "*With respect to disputes between investors of any Party and any Party, only the provisions of this agreement shall apply notwithstanding Most-Favored-Nation Treatment obligations of this agreement. For greater clarity, Parties' Most-Favored-Nation Treatment obligations under Chapter 12 (Investment) are limited to the extent that Investors may not raise claims based on provisions of other agreements that may exist between the Parties."*

[11] *RDC v. Guatemala*, para. 207. Also see *RDC v. Guatemala*, paras. 208-211.

[12] *RDC v. Guatemala*, para. 219.

[13] *RDC v. Guatemala*, paras. 216-218.

[14] *L.F.H. Neer and Pauline Neer (U.S.A.) v. United Mexican States* (1926) 4 R.I.A.A.

[15] *RDC v. Guatemala*, para. 217.

[16] *RDC v. Guatemala*, para. 218.

[17] *RDC v. Guatemala*, para. 235.