



UPPSALA  
UNIVERSITET

Department of Law  
Spring Term 2017

Master Programme in Investment Treaty Arbitration  
Master's Thesis 15 ECTS

# The Role of Legitimate Expectations Balancing the Investment Protection and State's Regulations

Can States Have Legitimate Expectations?

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## List of Abbreviations

Art	Article
BIT	Bilateral Investment Treaty
CETA	Comprehensive Economic and Trade Agreement
CSR	Corporate Social Responsibility
ECHR	European Court of Human Rights
EFTA	European Free Trade Association
FET	Fair and Equitable Treatment
FIPA	Foreign Investment Promotion and Protection Agreement
FTA	Free Trade Agreement
ICJ	International Court of Justice
ICSID	International Centre for Settlement of Investment Disputes
IIA	International Investment Agreement
ILO	International Labour Organization
ISO	International Organization for Standardization
NAFTA	North American Free Trade Agreement
OECD	Organization for Economic Co-operation and Development
p.	page
para	paragraph
TPP	Trans-Pacific Partnership
UN	United Nations
VCLT	Vienna Convention on the Law of Treaties

## Chapter 1: Introduction

The concept of legitimate expectations has often been used in international investment arbitration by the parties and tribunals to determine and delimit the standards of protection of the investment. The term was first used in English law as a ground of judicial review in administrative law<sup>1</sup>. In recent arbitral practice, legitimate expectations a widely accepted concept particularly in the context of expropriation and fair and equitable treatment (FET) claims in international investment arbitration.

Legitimate expectations refer to expectations of the foreign investors from the host states to act in a certain manner in relation to investment. These expectations arise from the specific conducts, promises, commitments or representations made implicitly or explicitly by the host states. For instance, the assurances of the host state to not to change the law or alter the legal system that gives the possibility for a productive investment constitute legitimate expectations. Changes in the regulations, revocations of the licenses can be a foundation for alleging breach of legitimate expectations.

The invocation of legitimate expectation in relation to expropriation mainly takes place in cases of indirect expropriation. Traditionally, expropriation occurs in the form of direct seizure of the property, however in the vast majority of the cases nowadays, the taking emerges as indirect expropriation. Indirect expropriation deprives the investor of the use of the investment, renders it worthless, or destroys it, even though the title remains untouched<sup>2</sup>. In this context, there is a possibility to use the regulatory powers of the state as a tool to take the investment in a manner that tantamounts to expropriation. The legal framework of the host country is a fundamental consideration for investors; therefore the legitimate expectations become relevant for the standards of protection provided in investment treaties.

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<sup>1</sup> Schmidt v Secretary of State for Home Affairs [1969] 2 Ch 149 (CA)

<sup>2</sup> Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law* (2nd edn, Oxford University Press 2002), p. 101.

Noting that every hindrance to investment does not suggest expropriation; several recent arbitral tribunals have defined the indirect expropriation in a narrow sense<sup>3</sup>. Instead, the fair and equitable treatment of the investor finds a larger field of application. The interferences to the investment accepted as a breach of FET more often than it is accepted as an expropriatory action. The investors' expectations are analyzed in depth in FET standard. Stability and consistency of the host states' legal order are accepted as one of the main factors for an investment-friendly climate<sup>4</sup>. Tribunals consider a change in the legal framework after the time that investment was made as a breach of FET standard because of the frustration of the investors' legitimate expectations<sup>5</sup>.

In FET standard and indirect expropriation, legitimate expectations are used by the tribunals as a tool for determining whether there is a breach of related clauses in investment treaties. Fundamentally, the framework of the application of legitimate expectations is the same, but it is safe to say that in FET standards, the concept has a more direct effect while in expropriation it is merely a consideration in the "checklist" of the tribunals deciding whether an expropriation occurred.

Almost in every arbitral award given in investment arbitration, the concept of 'legitimate expectations' has been invoked by the claimants and applied by the arbitral tribunals<sup>6</sup>. The legitimate expectation is a rooted concept in investment law, however as pointed out by many tribunals and scholars, it lacks a clear definition. Rather, it comprises the collection of the applications of the previous tribunals. The concept is accurately described as a "house of cards built by the references to other tribunals and academic opinions".<sup>7</sup> Notwithstanding this conceptual ambiguity, the doctrine of legitimate expectations has been used by the

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<sup>3</sup> *Pope & Talbot, Inc v. Canada*, Interim Award, 26 June 2000, paras. 96-98.; *Metalclad Corporation v. The United Mexican States*, ICSID Additional Facility Rules Case No. ARB (AF)/97/1, Award, 30 August 2010.

<sup>4</sup> Rudolf Dolzer, 'Fair And Equitable Treatment: Today's Contours' (2014) 12 Santa Clara Journal of International Law, p. 12.

<sup>5</sup> *Metalclad v. Mexico*, para 99.; *Técnicas Medioambientales Tecmed, S.A. v. Mexico*, ICSID Additional Facility Rules Case No. ARB (AF)/00/2, Award, 29 May 2003, para 154.

<sup>6</sup> Michele Potesta, 'Legitimate Expectations In Investment Treaty Law: Understanding The Roots And The Limits Of A Controversial Concept' (2013) 28 ICSID Review, p. 1.

<sup>7</sup> Anthea Roberts, Power and Persuasion in Investment Treaty Interpretation: The Dual Role of States, 104 *The American Journal of International Law*, 179 (2010).

tribunals<sup>8</sup>. Observing the mainstream approach taken by the tribunals in the application of legitimate expectations, one may concern about the wide scope of the interpretation given to the tribunals.

It is an asymmetric protection provided in investment law between the host states and the investors. However, in recent years, the idea that the investor protection and the host states' rights to regulate should be balanced has started to form in investment law. The host state's desire to regulate in certain areas while the investor relies on the stability of the legal environment. Every time a regulation change or administrative action made by the state, the investor may claim a breach of the treaty protection because the actions affect the investment by violating the legitimate expectations of the investor. To avoid such wide application of the treaty protection, a balance should be created between states right to regulate and investors' alleged violation of legitimate expectations resulting in economic loss. Several approaches have been introduced and discussed by the scholars to implement that balance. This paper will analyze the possibility to reach a more balanced conduct between parties by recognizing the right of the states to invoke the defense of legitimate expectations.

States have several factors to take into consideration when initiating new regulations. The investors' behaviors in the host state may be a valid concern as well. For example, an industrial activity of the foreign investor may increase the pollution in the air or water. In such case, the host state would react and take steps to regulate the standards for environmental protection. As a result of the regulation, the investment that does not meet the standards would be obliged to take measurements which eventually have an unfavorable effect on it. If the foreign investor initiates international arbitration seeking protection provided in the treaty, the state does not possess an effective tool to defend its actions. In a situation like this, recognizing the legitimate expectations of the states would provide a defense mechanism to the state. The state also can defend that it has legitimate expectations from the investor to not to create pollution.

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<sup>8</sup> David Gaukrodger, 'The Balance Between Investor Protection And The Right To Regulate In Investment Treaties: A Scoping Paper' (OECD Working Papers on International Investment 2017), p.26.

In cases that the states regulate a certain area due to the harms arising from the conducts of investments, the investors are still entitled to have treaty protection by claiming a breach of legitimate expectations of the unchanging regulatory framework. This application of the investment protection supports the asymmetric protection of the interests of the parties. By recognizing the host states' legitimate expectations, a balance between the states regulatory rights and the legitimate expectations of the parties can be achieved. The balance between the parties is needed to eventually create a more welcoming environment for the parties by strengthening the legitimacy of the investment arbitration system.

### **1.1. Purpose, Problem and Delimitation**

The purpose of this thesis is to provide another standpoint to develop the arguments around the balancing powers of the parties by examining the possibility for states to invoke legitimate expectations. The endeavor is to identify the problems and analyze a new way as the solution to the problem. Providing a certain and conclusive solution is a far-reaching objective of this thesis; therefore the main goal is to analyze the possibility for the states to have legitimate expectations by aligning the potential instruments that can be used and discuss the problems surrounding the invocation of the concept.

The thesis focuses on the analysis of the possibility for states to have legitimate expectations in order to create a balance between the state's regulatory powers and investor's legitimate expectations. There are two main questions to be answered. The first question is whether or not the current approach of the tribunals reconciling the legitimate expectations of the investors and the regulatory powers of the states is sufficient to have a balance between the parties. The second question is what are the possible indicators that can be interpreted as the source of legitimate expectations of host states and how can these expectations contribute the balance between the parties.

In order to understand the boundaries of legitimate expectations in relation to regulatory powers of the states, the current approach of the legal practice has a certain importance. Investors' expectations are invoked in alleged breaches of the FET and expropriation clauses. Thus, one of the purposes of this thesis is to

analyze the criteria used by the tribunals to determine the legitimate expectations in relation to indirect expropriation and to what extent they protect these expectations.

Hereafter, an analysis of the criteria used by the tribunals to determine the legitimate expectations in relation to FET standard and to what extent they protect the legitimate expectations in comparison with the protection of the regulatory powers of the state.

Finally, this thesis aims to discuss the possibility for states to have legitimate expectations as a balancing element and suggesting new ways invoke a successful “legitimate expectations” claim for the states.

The proposed method to initiate legitimate expectations is based on the promises or the commitments of the investors in several areas such as the environmental protection, human and labor rights. The corporate social responsibility (CSR) documents that the investors produce could also be accepted as a commitment to maintain the business respecting the host states’ standards.

The thesis does not cover the entire field of legitimate expectations applications *per se*. Only the applications of the tribunals which discussing the regulatory powers of the states and the legitimate expectations in providing balance will be examined. The focus will be on legitimate expectations; therefore the concepts of expropriation and FET will not be discussed in depth; only a general description of these protection standards will be provided to establish the legal and conceptual foundation better.

## **1.2. Methodology and Sources**

The sources of international law are the international conventions, international custom, the general principles of law and judicial decisions as stated in Article 38 of the ICJ Statute<sup>9</sup>. International conventions are one of the main sources of this thesis. Since the investment treaty arbitration relies on treaties and their

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<sup>9</sup> United Nations, Statute Of The International Court Of Justice, <http://www.icj-cij.org/documents/?p1=4&p2=2#CHAPTER II>

interpretation, Vienna Convention on the Law of Treaties<sup>10</sup> is another main source. In addition, a significant number of bilateral agreements (BITs), multilateral agreements, free trade agreements (FTAs) and other legal instruments generally known as international investment agreements (IIAs) are the sources of this paper as well as a number of arbitral awards and scholarly opinions.

In the conduct of the research of this thesis, first the general application of the legitimate expectations by the tribunals has been discussed. The teleological method has used to discuss the ordinary meaning, purpose, and intention of the treaties and the awards. The legal-deductive method is used to have a clear picture of legitimate expectation and to what extent it applies to the decisions of the tribunals. After discussing the application of the tribunals in cases of investors' invocation of legitimate expectations; the indicators of possible claims for the legitimate expectations of states have been discussed. The indicators that may be inferred as a source of legitimate expectations for the states have been elaborated by using the method of systematization. The starting point of the systematization is the actions of the states that have been accepted as an act that leads to legitimate expectations by the tribunals. This paper is hoping to achieve the *de lege ferenda* by creating a balanced investment protection system using the recognition of the legitimate expectations of the states. A combination of the rules, theories, and concepts was provided to analyze the possibility for the host states to have legitimate expectations. The problems may arise in invoking these expectations in the current investment system are described, and several claims raised by the host states were presented in order to give a perspective on legitimate expectations of the host states.

In order to achieve the purpose of the thesis, the description of the *de lege lata* will be given first. The tribunals' practice on the legitimate expectations will be analyzed limited to in relations of regulatory powers of the states.

The purpose of the thesis is not only to provide a study how the tribunals interpreted the legitimate expectations in cases of pleading a breach of standard of protections of the investments by the changes in the legal framework of the host

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<sup>10</sup> United Nations, *Vienna Convention on the Law of Treaties*, 23 May 1969, United Nations, Treaty Series, vol. 1155, p. 331

state; but also introduce a new approach to maintain the balance between the protection of the investment and the state's right to regulate. By introducing the possibility for the host states to have legitimate expectations and suggestions how the future investment agreements should contain, the thesis aims to provide a start point for a future discussion to achieve *de lege ferenda*.

### **1.3. Structure**

In Chapter 2 the current approach of the investment tribunals will be examined in relation to FET protection. The vagueness of the legitimate expectations and its reflections on the tribunals' interpretation of the issues will be outlined. The case law will be again two-fold: the approach defending the protection of the legitimate expectations of regulatory changes and the approach concluding that the changes in regulatory framework may not necessary mean a contravention of the legitimate expectations of the investors. In Chapter 3, the same analysis will be given focusing indirect expropriation. The case law will be classified under two main titles. First, the approach taken in favor of the strong protection of the legitimate expectations by means of stabilizing the regulatory framework will be discussed. The second part of the Chapter will be the general description of the case law in favor of the protection of the regulatory powers of the state, and how this approach improved the balance between the investors and host states. In Chapter 4, in the light of the current arbitral practice, the possibility for host states to have legitimate expectations as a method of balancing the investment protection and states' right to regulate will be discussed. The main problems arising out of the invocation of the legitimate expectations for the host states will be outlined, and possible claims without the explicit treaty obligation will be provided. In the end, some suggestions will be given in order to achieve a balance between the investment protection and regulations of the states by entitling the host states to invoke legitimate expectations.

## **Chapter 2 – Legitimate Expectations and Fair and Equitable Treatment Standard**

Legitimate expectations have become one of the major standards that the tribunals apply in investment treaty law in order to determine a violation of fair and

equitable treatment. Indirect expropriation claims include the invocation of legitimate expectations as well, but the main application of the protection of expectations with a greater chance of success is in FET standards.

One of the first tribunals which stated that FET encompasses protection of expectations was the *Tecmed* tribunal<sup>11</sup>. The tribunal declared that “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 and 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<sup>12</sup>”. After this first explanation of the concept, the tribunals accepted that the legitimate expectations can be based on the host state’s legal order<sup>13</sup>, contractual commitments<sup>14</sup> and government representations<sup>15</sup>.

Despite the fact that legitimate expectations are accepted and applied by the vast majority of the tribunals, the arguments around the concept have continued. The ambiguity in definitions raises questions especially regarding the scope of the application. The investments rarely mentioned the protection of the legitimate expectations specifically. The FET protection is mentioned in a minimal language that gives a wide scope for tribunals applying the standard to interpret the text<sup>16</sup>. When it comes to legitimate expectations, the tribunals continue to use their broad discretion to decide whether an action taken by the host state violates the legitimate expectations of the investor. The simple request of respecting the investors’ expectations may result to have unlimited expectations due to the nature of undefined treaty obligations. The broad scope of legitimate expectations creates the discussion whether the investors have excessive benefits of the

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<sup>11</sup> Potesta, p. 99.

<sup>12</sup> *Tecmed v Mexico*, para 154.

<sup>13</sup> *Marvin Roy Feldman Karpa v. United Mexican States*, ICSID Case No. ARB(AF)/99/1, Award, 16 December 2002, para 128.

<sup>14</sup> *Continental Casualty Company v. The Argentine Republic*, ICSID Case No. ARB/03/9, Award, 5 September 2008, para 261.

<sup>15</sup> *Southern Pacific Properties (Middle East) Limited v Arab Republic of Egypt*, ICSID Case No ARB/84/3, Award, 20 May 1992, para 82.

<sup>16</sup> Christopher Campbell, 'House Of Cards: The Relevance Of Legitimate Expectations Under Fair And Equitable Treatment Provisions In Investment Treaty Law' (2013) 30 Journal Of International Arbitration, p. 362.

situation. The border between a regulatory change and violation of the legitimate expectations due to a change in host state's legal order is unclear.

The investors' expectations may arise out of the changes in the regulatory framework, even in the absence of specific commitments not to change the system<sup>17</sup>. When the investment still exists, and the operations related to the investment continue, changing the regulatory framework could frustrate these expectations and result in a breach of FET standard.<sup>18</sup> Given how creating a general standard applicable to all cases is practically impossible. The tribunals have instead adopted different standards taking into account the facts of each case. Most discussions relating to legitimate expectations revolve around the balance between legitimate expectations of investors and sovereign prerogatives of states, such as regulatory authority.

## **2.1. Lower Threshold in Application of Legitimate Expectations**

The tribunals adopting this approach have a lower threshold to define the legitimate expectations of the investor. Changing regulations that may affect the investors' business are accepted as a breach of FET because of the legitimate expectations. It is unreasonable for a prudent investor to believe that a local law in the host country will never change, yet the extent of the modification is the determining factor here.

In *Enron v Argentina* case, the tribunal applied a very low standard to the protection of legitimate expectations<sup>19</sup>. *Enron* is one of the cases that brought in front an ICSID tribunal after the economic crises in Argentina. The claimant was a US investor with indirect equity participation in the Argentinian gas company, TGN. Argentina amended its regulatory framework promulgating the "Emergency Law" which eliminated the calculation of tariffs in US dollars. The tariff was set to pesos at the rate of one dollar to one peso and followed by a devaluation of pesos which decreased the value of the company immensely. Enron claimed that

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<sup>17</sup> Abhijit PG Pandya and Andy Moody, 'Legitimate Expectations In Investment Treaty Arbitration: An Unclear Future' (2017) 15 *Tilburg Law Review*, p. 95.

<sup>18</sup> Potesta, p. 110.

<sup>19</sup> *Enron Creditors Recovery Corporation Ponderosa Assets LP v. The Argentine Republic*, ICSID Case No. ARB/01/3, Award, 30 July 2010.

the change in the laws breached the FET standards and did not act in legitimate expectations of the investor.

The tribunal the Tribunal pointed out that a “key element of fair and equitable treatment is the requirement of a ‘stable framework for the investment<sup>20</sup>” by referring the Preamble of the US-Argentina BIT that accepting FET standard of investment as a necessity to maintain a stable framework for the investment<sup>21</sup> as well. The expectations taken into account by the foreign investor to make the investment should be protected. Enron tribunal followed the previous tribunals that characterize the legitimate expectations as “reasonable and justifiable<sup>22</sup>.” Enron invoked the state of necessity as a ground for the regulatory changes; however, the tribunal declined this defense and concluded that Enron relied upon the conditions established by the Respondent’s legal framework. “Given the scope of Argentina’s privatization process, its international marketing, and the statutory enshrinement of the tariff regime, Enron had reasonable grounds to rely on such conditions.” By changing the regulations that dominate the investment, Argentina failed to provide a stable framework as required by the BIT and breached the legitimate expectations of the investor.

In *CMS v. Argentina*<sup>23</sup>, the tribunal took a similar approach. The factual basis of the case was identical to *Enron* case, mainly the economic loss after the regulatory change in Argentina due to the economic crises they faced. *Enron* tribunal also referred the Preamble that attests the protection of stable framework. The tribunal concluded that dispensing the framework in contrary to the specific commitment made in the BIT resulted a breach is the FET standard. By combining the Preamble and FET protection, the tribunals accepted a high level of protection in favor of the investors.

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<sup>20</sup> *ibid*, para 260.

<sup>21</sup> Treaty between United States of America and the Argentine Republic Concerning the Reciprocal Encouragement and Protection of Investment (signed 14 November 1991, entered into force 20 October 1994), Preamble.

<sup>22</sup> *International Thunderbird Gaming Corporation v. United Mexican States*, Arbitral Award, 26 January 2006, para 147.

<sup>23</sup> *CMS Gas Transmission Company v. The Republic of Argentina*, ICSID Case No. ARB/01/8, Award, 12 May 2005, paras 273-284.

Another tribunal followed the strict protection of the legitimate expectations of the investor is *Occidental v. Ecuador*. The Claimant, Occidental was a US company had a contract with an Ecuadorian state corporation to explore and produce oil. The dispute was about the VAT reimbursements that the state refused to pay with a new amended decree. The tribunal said that the stability of legal framework is an essential part of the fair and equitable treatment standards. Further, the states have a duty to prevent the alteration to the legal and business environment that the investment was made<sup>24</sup>. *LG&G* tribunal supported the developing line of decisions on the regulatory stability and the expectations of the investors in that matter. They pointed out that Argentina completely disrupts the legal environment which was the reason to attract the foreign investment in the first place. Thereby, the change of regulatory framework was a breach of FET standards.

The jurisdiction in Argentina cases and Occidental suggest that the expectations arising from the regulatory changes would be a solid enough ground. However, combining the Preamble and the legitimate expectations in FET standards has encountered some criticism, suggesting that the standards applied by the tribunals are unreasonably high.

## **2.2. Balancing Approach in Favor of Regulatory Rights of the States**

Tribunals defending a more balancing approach, generally speaking, stated that the expectation of “frozen” legal framework is unrealistic. The states have the right to amend its regulations to adapt it to possible needs. However, if the states fail to provide a consistent framework from the beginning, or clearly fails to comply with the specific commitments made in the form of stabilization clauses in the contract, the legitimate expectations of the investor would be frustrated.

In *Saluka v. Czech Republic* case, the tribunal supported the state’s right to do regulatory changes. After the end of the communist rule in the Czech Republic, the government reconstructed the banking sector. The shares of one of the State-

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<sup>24</sup> *Occidental Petroleum Corporation and Occidental Exploration and Production Company v. The Republic of Ecuador*, ICSID Case No. ARB/06/1, Award, 5 October 2012, paras 183-191; Potesta, p. 111.

owned bank sold to a Japanese company and transferred to its subsidiary, Saluka which constituted under the laws of Netherlands<sup>25</sup>. After having financial difficulties, the bank that investor holds its shares was placed under forced administration<sup>26</sup>. The Claimant, after that, brought the dispute to the tribunal claiming breach of FET provision under the Dutch-Czech Republic BIT<sup>27</sup>.

The tribunal remarked that the protection provided under the Treaty could not solely be based on the investor's "subjective motivations and considerations." Moreover, the tribunal stated that the standard to determine whether the legitimate expectations of the investor are frustrated, "the legitimacy and reasonableness of the expectations should be considered in light of the circumstances."<sup>28</sup> After analyzing the applicable standard of legitimate expectations, the tribunal concluded that the Czech Republic frustrated *Saluka's* legitimate expectations regarding the treatment of the investment.

In *Parkerings v. Lithuania* case, the Claimant alleged that the state violated the FET standard by frustrating the legitimate expectations. In this case, the Claimant *Parkerings* was a Norwegian company engaged in construct and operate car parks in Vilnius Municipality through its Lithuanian subsidiary *BP*. The contract between the parties included enforcing the parking laws of the city with the right of collection of the parking and clamping fees. After the contract was signed, the government made modifications of the Law on Local Fees, and Charges and the amendment of the Decree on Clamping prevented the Claimant from receiving an important part of its income<sup>29</sup>. The Claimant alleged that the state frustrated investor's investment-backed expectations.

The tribunal stated that "FET standard is violated when the investor is deprived of its legitimate expectation that the conditions existing at the time of the Agreement

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<sup>25</sup> *Saluka Investments B.V. v. The Czech Republic*, UNCITRAL, Partial Award, 17 March 2006, para 1.

<sup>26</sup> *ibid*, para 55.

<sup>27</sup> Agreement on Encouragement and Reciprocal Protection of Investments between the Kingdom of the Netherlands and the Czech and Slovak Federal Republic (signed '9 April 1991, entered into force 01 October 1992), Article 3.

<sup>28</sup> *Saluka v. Czech Republic*, para 304.

<sup>29</sup> *Parkerings-Compagniet AS v. Republic of Lithuania*, ICSID Case No. ARB/05/8, Award, 11 September 2007, para 328.

would remain unchanged”<sup>30</sup>. States would enjoy undeniable right and privilege to exercise its sovereign legislative power, thereby unless the government made specific assurances about the unchanging laws or includes a stabilization clause in the investment contract, the changes in regulations alone would not frustrate the legitimate expectations of the investor. The characteristics in the host state suggest a transition period between the former Soviet laws to modern laws; therefore expecting an unchanging legal framework is unlikely. The investor must anticipate that the circumstances could change, and thus structure its investment in order to adapt it to the potential changes of legal environment<sup>31</sup>.

At the end of the discussion about the relation between the government’s regulations and the legitimate expectations of the investor, it is concluded that “the tribunal is not persuaded that the Claimant had any legitimate expectation that the Government of the Republic of Lithuania would not pass legislation and regulatory measures which could harm its investment<sup>32</sup>”.

Another case worth mentioning is *Total v. Argentina*. The dispute is related to the change of laws after Argentinian economic crises. The tribunals in this, contrary to other tribunals of Argentinian cases adopted an approach providing a certain balance in favor of the regulatory rights of the States unless any specific commitments were made by the state. The tribunal observed that “signatories of investment treaties do not thereby relinquish their regulatory powers or their duty to adapt their legislation to changing conditions. Such limitations upon a government should not lightly be read into a treaty which does not spell them out clearly nor should they be presumed”<sup>33</sup>. The state may give certain commitments or promises to not to alter with the legal framework. Also, the investment contracts between the parties may include stabilization clauses that lead to legitimate expectations of the investor. In the absence of promises made explicitly

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<sup>30</sup> *ibid*, para 330.

<sup>31</sup> *ibid*, paras 331-335.

<sup>32</sup> *ibid*, para 338.

<sup>33</sup> *Total S.A. v. The Argentine Republic*, ICSID Case No. ARB/04/01, Decision on Liability, 27 December 2010, para 115.

or implicitly by the state, “general stabilization requirement would go beyond what the investor can legitimately expect”<sup>34</sup>.

According to the tribunal, the expectations which are rooted in the regulation of a normative and administrative nature that is not specifically addressed to the relevant investor are not under the protection of the concept of legitimate expectations. However, the tribunal did not exclude the possibility of a stability claim for the regulations that designed to provide a legal framework for the investment. The tribunal concluded that “a claim to stability can be based on the inherently prospective nature of the regulation at issue aimed at providing a defined framework for future operations. This is the case for regimes, which apply to long-term investments and operations, and providing for “fall backs” or contingent rights in case the relevant framework would be changed in unforeseen circumstances or case certain listed events materialize.”<sup>35</sup>

*Continental v. Argentine*<sup>36</sup> tribunal also differentiated between the general administrative acts of the government and the investor-specific change in the regulatory framework and gave more scrutiny to contractual undertakings. *PSEG v. Turkey*<sup>37</sup> and *El Paso v. Argentine Republic*<sup>38</sup> tribunals also adopted a similar approach in their decisions.

### **2.3. Concluding Remarks**

Legitimate expectations have a wide area of application in FET. The absence of a specific definition of the term gives the investors a large field to define their expectations.

The case law, in general, the conditions for the investors to have legitimate expectations is not uniform among the tribunals. Several tribunals accepted the changing laws as a sufficient ground for investors to claim breach of FET

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<sup>34</sup> *ibid*, para, 120.

<sup>35</sup> *ibid*, para 122.

<sup>36</sup> *Continental v. Argentina*, para 261.

<sup>37</sup> *PSEG Global, Inc., The North American Coal Corporation, and Konya Ingin Elektrik Üretim ve Ticaret Limited Sirketi v. Republic of Turkey*, ICSID Case No. ARB/02/5, Award, 19 January 2007, para 243.

<sup>38</sup> *El Paso Energy International Company v. The Argentine Republic*, ICSID Case No. ARB/03/15, Award, 31 October 2011, para 364.

standards by their legitimate expectations. The standards adopted by the tribunals varies by the facts of the cases. The recent changing trend of the decisions suggests that the mere fact that there have been some changes in the regulations does not mean a frustration of the legitimate expectations of the state. Rather, the tribunals require a higher standard of commitments in the form of stabilization clauses or specific promises for proper invocation of legitimate expectations.

As explained above, the ambiguity around the concepts of both FET and legitimate expectation, lead the tribunals to have a wide discretion when deciding on these issues. In recent decisions, the tribunals gave more scrutiny to specific measurements of the host state that only affects the certain investor claiming a breach of FET; instead of a general regulatory change. If the future tribunals follow that understanding, the goal of balancing the interests of the disputing parties will be one step closer to achieve.

### **Chapter 3: Legitimate Expectations and Indirect Expropriation**

Expropriation fundamentally can be defined as taking of property that belongs to the investor by the state <sup>39</sup> which is the most serious threat to the foreign investor.<sup>40</sup> For that reason, international investment agreements intend to protect against expropriation. In international disputes between the host states and the foreign investors, the investors often claim that the host states expropriated their investment. Expropriation, however, is not only limited to depriving the investor of legal title or taking of the property which can be defined as direct expropriation. Instead in most cases, expropriation occurs in the form of indirect expropriation. The term indirect expropriation defines the situations that the “host states reduce the benefits of the investors derived from its investment”<sup>41</sup> without actually taking away the control or the title of the investor by invoking legislative powers.

A typical BIT covers indirect expropriation as well as direct expropriation under its protection, using phrases as “indirect expropriation” and “measures equivalent

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<sup>39</sup> JW Salacuse, *The Law of Investment Treaties* (2nd ed, Oxford University Press 2015), p.322.

<sup>40</sup> Kaj Hobér, *Selected Writings On Investment Treaty Arbitration* (Studentlitteratur 2013), p 135.

<sup>41</sup> Salacuse, p. 325

to/tantamount to expropriation.” However, the definition and the conditions of indirect expropriation have not clearly stated in most BITs; thus the tribunals are responsible for determining the situation and if it constitutes an indirect expropriation.

Legitimate expectations of the investors play a significant role in guiding arbitral tribunals applying the BIT standards of protection.<sup>42</sup> Even though the legitimate expectations are associated with FET, the tribunals use them in relation to indirect expropriation as well. Legitimate expectations of the investors are one of the considerations that can be affected by the decision of the tribunal<sup>43</sup>.

In some BITs, the foreign investors’ legitimate expectations are protected in order to provide a certain standard in relation to the expropriation. For example in US Model BIT, “reasonable investment-backed expectations” of the investors is one the factors considered in order to determine if state takes an action that constitutes indirect expropriation.<sup>44</sup> A similar provision can be found in Canada Model BIT.<sup>45</sup>

However, in most BITs and IIAs legitimate expectations are not defined or counted as one of the circumstances to be considered in determining expropriation. In those cases, the tribunals relied on international law to establish a standard for the role of the legitimate expectations in indirect expropriation. The positions taken by the tribunals can be summarized under two categories, some tribunals adopted high standards for the investors to have legitimate expectations; while others argued that minor changes in state conduct violate the legitimate expectations of the investor.

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<sup>42</sup> Anna De Luca, 'Indirect Expropriations And Regulatory Takings: What Role For The “Legitimate Expectations” Of Foreign Investors?', *General Interests of Host States in International Investment Law* (1st edn, Cambridge University Press 2014), p.4.

<sup>43</sup> Schuer, *Principles of Investment Law*, p. 113.

<sup>44</sup> 2012 U.S. Model Bilateral Investment Treaty, Annex B (4)(b).

<sup>45</sup> Canada Model BIT, Annex B13(1)(b)(ii).

### **3.1. Protection of the Legitimate Expectations of the Investor**

The tribunals took a wide understanding to designate the legitimate expectations of the foreign investor and took measures nearly disregarding usage of regulatory power or alteration of the government conduct.

A typical example of this approach is *Metalclad v. Mexico* case. The dispute was brought before an ICSID tribunal under NAFTA. The Claimant, Metalclad was an enterprise of the United States of America operating through its Mexican subsidiary COTERIN.<sup>46</sup> The federal government of Mexico granted the Claimant to construct and operate a transfer station for hazardous waste in Guadalcazar, Mexico. After five months from the starting of the construction, the Claimant received a notice asserting impropriety of the construction before receiving a municipal construction permit. Metalclad applied for a permit and finished the construction in the meantime.

The permit was rejected by the municipality, and shortly after the Governor issued a decree named “Ecological Decree” declaring a protected natural area for the protection of a rare type of cactus. The protected area included the landfill. Therefore, the landfill was shut down permanently.

Metalclad claimed a violation of NAFTA Article 1110 and requested compensation for the expropriation of the investment. The tribunal took into consideration that the federal government gave a permit to construct at the first place and the governor assured Metalclad that the permit would be granted.

The tribunal held that the exclusive authority for siting and permitting a hazardous waste landfill resides with the Mexican federal government. The municipality claimed that the ecological concerns regarding the environmental effect and impact on the site and surrounding communities were a prominent factor to reject the permit. The tribunal found that the reasons to deny the permit were not related to the physical construct of the landfill. Moreover, the representation of Mexico in federal level regarding the permit implied that the investor had “justified

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<sup>46</sup> *Metalclad v. Mexico*, paras 2-3.

reliance”<sup>47</sup> on the government conduct. The tribunal concluded that the investor began the construction relying on the representation of the government but the permit was never granted.

As a result of the refusal of the permit, the investor was unable to use its investment which amounts to an indirect expropriation according to the Tribunal. Furthermore, the tribunal clearly stated that the motivation or the intentions behind the Ecological Decree were insignificant.<sup>48</sup> The Ecological Decree adopted after the initial claim of the Claimant. Therefore the Respondent invoked the Ecological Decree as a plea for legitimatizing the refusal. The decision was based on the protection of the legitimate expectations of the investor and merely discussed the motivation behind the actions of the government.

Another decision based on the similar issues is *Tecmed v. Mexico*. Tecmed tribunal adopted the principle of proportionality which built on the jurisprudence of European Court of Human Rights (ECHR). The tribunal states that the states are entitled to take measures tantamount to indirect expropriation, but the measures should be proportionate to its purpose.<sup>49</sup>

The Spanish company Tecmed operated landfill of hazardous industrial waste through its Mexican subsidiary Cytrar. Hazardous Materials, Waste and Activities Division of the National Ecology Institute of Mexico (INE) as the regulatory body on the environmental issues granted one year permit to Cytrar in 1996. The permit was renewable after each year. The permit was renewed after a year, but in the second year, 1998, INE refused to renew the permit. Tecmed initiated arbitration under Spain-Mexico BIT in front of an ICSID tribunal.

Proportionality analysis applied by the tribunal required to find a balance between the interests of the parties, specifically, the balance between the protection of the investment and the state’s regulatory powers on the matters of public interest. The approach also included legitimate expectations of the investor. The tribunal stated that “Although the analysis starts at the due deference owing to the State when

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<sup>47</sup> *ibid*, para 108.

<sup>48</sup> *ibid*, para 111.

<sup>49</sup> More detailed study about the proportionality analysis: Han X, 'The Application of The Principle of Proportionality In *Tecmed v. Mexico*' (2007) 6 *Chinese Journal of International Law*.

defining the issues that affect its public policy or the interests of society as a whole, as well as the actions that will be implemented to protect such values, such situation does not prevent the Arbitral Tribunal, without thereby questioning such due deference, from examining the actions of the State in light of Article 5(1) of the Agreement to determine whether such measures are reasonable with respect to their goals, the deprivation of economic rights and the legitimate expectations of who suffered such deprivation.”<sup>50</sup>

The Respondent, according to the tribunal, denied renewal of the license based on the strict interpretation of the conditions that the Claimant first granted the permit. The first permit in 1996 and the following year’s extension were based on the Environmental Impact Declaration of 1994, “which projected a useful life of ten years for the Landfill.”<sup>51</sup> Under the circumstances of the case, even though the Claimant did not have a permanent permit, the tribunal accepted that the Claimant had legitimate reasons to believe that the operation of the Landfill would extend over the long term<sup>52</sup> and the permit would be renewed.

The tribunal concluded that the measures taken by the government were amount to expropriation. In its analysis, the tribunal used the legitimate expectations of the investor as one part of the reasoning to determine whether an indirect expropriation had occurred. The tribunal used a more balancing approach than *Metalclad* case, but still protected the legitimate interest of the investor in the end.

### **3.2. Protection of Regulatory Powers of the State over the Legitimate Expectations of the Investors**

Various tribunals and scholars took a critical approach to legitimate expectations of the investors. Since the scope of legitimate expectations has been unable to define clearly; some tribunals had the concern that the current approach is a wider application of the concept than intended. Therefore, the legitimate expectations should not amount to stabilization clauses or insurance policies in the application.

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<sup>50</sup> *Tecmed v. Mexico*, para 122..

<sup>51</sup> *Ibid*, para 150.

<sup>52</sup> *ibid*, para 149.

Particularly in the matters of environmental protection, it is clear that “one cannot postulate that the environmental regime should be frozen, especially in the case of large-scale economic development projects and technological innovation and changing environmental expectations and accepted standards.”<sup>53</sup> Environment and human health are some of the most regulated areas by the governments, and it is expected by the tribunals that the investors should be aware of these factors.

In *Methanex v. USA* case, the risk of regulatory changes has been discussed under the NAFTA Article 1110. Methanex is a Canadian company with a US subsidiary, produces methanol which is a key component in a gasoline additive known as MTBE<sup>54</sup>. After State of California had banned the usage of MTBE due to environmental and public reasons, Methanex brought a claim under NAFTA in front of an ICSID arbitration claiming that the banning was tantamount to expropriation *inter alia*. The ban in California did not interfere directly with the methanol business, but the main purchase of the product was to be used in MTBE production. Respondent argued MTBE constituted a risk of contamination of drinking water when it leaked from underground tanker and pipelines. The scientific reports presented in the case also supported that finding.

The tribunal found that the Respondent did not make specific commitments or there are no representations made by the host State which was reasonably relied upon by the claimant<sup>55</sup>. Furthermore, the tribunal stated that Methanex entered a political economy, invested in an area characterized to be strictly operated by the regulations in order to protect the public health and environment. Methanex “did not enter the United States market because of special representations made to it.” Therefore, in the absence of specific commitments respecting restraints on certain future regulatory actions, the investor’s expectations were not protected.

*MTD v. Chile* Annulment Decision, the ad hoc committee criticized the legitimate expectations approach taken by the tribunals stating that the “reliance on the

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<sup>53</sup> Thomas Walde and Abba Kolo, 'Environmental Regulation, Investment Protection And 'Regulatory Taking' In International Law' (2001) 50 International and Comparative Law Quarterly, p. 824.

<sup>54</sup> *Methanex Corporation v. United States of America*, Final Award of the Tribunal on Jurisdiction and Merits, 3 August 2005, Part I - Preface - Page 4 para 1.

<sup>55</sup> *Methanex v. USA*, Part IV - Chapter D - Page 4, para 8

foreign investor's expectations as the source of the host State's obligations (such as the duty to compensate for expropriation) is questionable."<sup>56</sup>

### 3.3. Concluding Remarks

Legitimate expectations have a weaker link to indirect expropriation comparing the FET standards. However, the tribunals still apply the concept as a part of the general assessment in order to determine whether an expropriation occurred. Changes in the regulatory framework to provide higher standards of protection of public interests may also harm the economic activities of investors.

*Metalclad* tribunal considered the effects of the measures taken by the governments, and how it frustrated the investors' expectations. The governments' motives to regulate found insufficient or unrelated. In *Tecmed* case, the tribunal applied a proportionality analysis which can be useful to balance the parties' interests. Nevertheless, the tribunal decided that indirect expropriation occurred based on the actions of the government can be interpreted as promises. In *Methanex* case, the tribunals interpreted the legitimate expectations of the investor in relation to the business risk they took. The expectations of the investor were not protected based on the finding that there were no specific promises to protect the regulatory framework. All of the decisions focused on the existence or the extent of the promises, instead of the incentives of the states. The assessment of the expropriation was single-sided; it only discussed the issues from the investor's perspective. The motivations of the states such as environmental protection when regulating the specific areas or revoking the licenses were not elaborated. In the current approach, the tribunals adopted the approach in favor of the either the investor or the host state considering the effects of the regulations or states' power to regulate only. In order to promote the investment arbitration and strengthen the legitimacy of the system, a balance between the parties' interest is essential. The proportionality applied by the *Tecmed* tribunal may be a good start to demonstrate a balance between the legitimate expectations and regulatory powers, but without the assessment of the motives of both parties the protection provided in investment law will continue to be asymmetric.

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<sup>56</sup> *MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile*, ICSID Case No. ARB/01/7, 21 March 2007, Decision on Annulment, para 67.

## Chapter 4: Can States Have Legitimate Expectations?

In IIAs the protection is offered to a foreign investor. Therefore the discussions on investors' rights and investment protection, by nature are focused on the claims of the investors. The wording of a typical BIT<sup>57</sup> attempts to cover all the related provisions about the investment protection i.e. expropriation and FET standards. Legitimate expectations of the foreign investors, explicitly or implicitly, are a part of that protection. As discussed in previous chapters, the tribunals accepted several approaches and methods to protect the legitimate expectations of the investors.

The ambiguity surrounding the definition of the concepts in investment law still prevails. The scholarly opinions and the tribunals repeatedly redefine some concepts such as FET standards, indirect expropriation, and the legitimate expectations. The broad application of the standards<sup>58</sup> may prevent the governments to regulate the legal framework of their countries in order to adopt the new developments or more enhanced standards of protection of public interests. Therefore, it is clear that a balance between the regulatory rights of the state and the legitimate expectations of the investment should be redressed.

“Legitimate expectations exist as a result of a promise, representation, practice or policy made, adopted or announced by or on behalf of the government or a public authority.<sup>59</sup>” By analogy, the representations made by the investors may create a base for the State claims related to legitimate expectations. In current investment treaties, protection of host states in such manner is not offered; however, states can claim expectations to a certain extent invoking the issues of public interests in the absence of explicit treaty protection.

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<sup>57</sup>Agreement between the Government of the United Kingdom and the Government of the Arab Republic of Egypt for the Promotion and Protection of Investments (signed 11 June 1975, entered into force 24 February 1976).

<sup>58</sup>Dolzer, 'Fair And Equitable Treatment: Today's Contours; Jan Paulsson, 'Indirect Expropriation: Is The Right To Regulate At Risk?' (Symposium Co-organised by ICSID, OECD and UNCTAD Making the Most of International Investment Agreements: A Common Agenda), 2015.

<sup>59</sup>Ng Siu-tung and Others v. HKSAR, Court Of Final Appeal Of The Hong Kong Special Administrative Region Final Appeal, Nos. 1-3 of 2001, para 92

One of the ways to maintain the balance is to enable the possibility for host states to invoke legitimate expectations concerning the behavior of foreign investors in their country. In this way, the expectations will exist on both sides, and a mutual satisfaction of the expectations will support the balance in the application of the investment protection standards.

The protection provided for the host states in investment arbitration in relation to the changes in the legal framework is usually related to environment protection or the protection of any other public interests such as the human rights or protection of the cultural and national properties. Hence, the commitments of the investors in these areas can indicate legitimate expectations of the host states. In this chapter, three different instruments can give ground for the invoking of the expectations will be discussed.

First of all, the legitimate expectations of the states can be based on the contractual commitments of the investor that creates a certain obligation elevates the commitment to the treaty level. Another basis for legitimate expectations claims can be unilateral representations made by investors. Instruments such as United Nations Guiding Principles on Business and Human Rights<sup>60</sup> and the OECD Guidelines for Multinational Enterprises<sup>61</sup> are the examples for the representations from the investors that can create expectations. In addition, the states also may invoke the legitimate expectations pursuant to investors conducts implementing their social responsibility and sustainable development policies such as Social Responsible Guidelines.

Starting from this argumentation, the problems about invoking the legitimate expectations for states and the possible opportunity to have legitimate expectations can be discussed in addition to the steps supposed to be taken in order to have a strong claim of legitimate expectations.

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<sup>60</sup> UN Guiding Principles on Business and Human Rights, HR/PUB/11/04, 2011, <[http://www.ohchr.org/Documents/Publications/GuidingPrinciplesBusinessHR\\_EN.pdf](http://www.ohchr.org/Documents/Publications/GuidingPrinciplesBusinessHR_EN.pdf)>.

<sup>61</sup> OECD (2011), OECD Guidelines for Multinational Enterprises, OECD Publishing. <<http://dx.doi.org/10.1787/9789264115415-en>>.

## 4.1. Legitimate Expectations of the States: Current Situation

### 4.1.1. First Steps: Contributory Fault and Investor's Conduct

The host states used different claims to argue that the investor's conduct also contributed the situation which the dispute has arisen from. One of the claims invoked by the states is the contributory fault defense. The states suggested that the actions taken by the investors lead them to take precautions in the form of regulatory changes or any other government conduct. Several Respondents attempted to invoke this claim such as *Yukos v. Russia*<sup>62</sup> and *Occidental v. Ecuador*<sup>63</sup>.

In *Yukos v. Russia*, the Tribunal identified “four instances of alleged willful or negligent conduct by the Claimants that could have potentially constituted fault contributing to the destruction of Yukos<sup>64</sup>” among the listed 28 instances of alleged illegal and bad faith conduct of the Claimants<sup>65</sup>, by the Respondent. In the end, the tribunal decided that the Claimant took actions in bad faith to abuse the tax regime of the country and stated that “claimants should pay the price for Yukos' abuse of the low-tax regions by some of its trading entities, including its questionable use of the Cyprus-Russia DTA, which contributed in a material way to the prejudice which they subsequently suffered at the hands of the Russian Federation.<sup>66</sup>” The tribunal found the measures taken by the Russian Federation was tantamount to expropriation, but the compensation was reduced due to the actions of the investor to abuse the tax regulations.

Following the same approach, the tribunals of *Occidental* and *MTD*<sup>67</sup> cases reduced the amount of the compensation due to contributory fault and investor's faulty conduct in the case. The concept of contributory fault is used to describe the consequences arising from the investors' conduct. The issues do not stem from

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<sup>62</sup> *Yukos Universal Limited (Isle of Man) v. The Russian Federation*, PCA Case No. AA 227, Final Award, 18 July 2014.

<sup>63</sup> *Occidental v. Ecuador*, para 660.

<sup>64</sup> *Yukos v. Russia*, para 1608.

<sup>65</sup> *ibid*, para 1281.

<sup>66</sup> *Ibid*, para 1634.

<sup>67</sup> *MTD v. Chile*, para 246; *Occidental v. Ecuador*, para 678.

the expectations of the states; but contributory fault resembles what legitimate expectations of host states could look like.

Another attempt was made in *Sempra v. Argentine* case. In early 1990s Argentina privatized the national gas distribution companies. During the privatization, the government introduced a system which used US Dollars in the calculation of the tariffs and their semiannual adjustment according to changes in the U.S. Producer Price<sup>68</sup> Index (PPI). The calculated price converted into pesos at the prevailing exchange rate at the time of billing. After the economic crises in Argentina, the government enacted “Emergency Law” aimed to eliminate right to calculate tariffs in U.S. dollars, and the convert the tariffs to pesos at the fixed rate of exchange of one dollar to one peso. The Claimant argued that the legal framework is designated to provide all necessary guarantees regarding fundamental safeguards of acquired rights and legitimate expectations.<sup>69</sup>

On the other hand, Argentine argued that “the Government also had many expectations in respect of the investment that was not met or was otherwise frustrated.”<sup>70</sup> In respect to this issue, Argentina state that the companies invested in the country are expected to “work diligently and in good faith, not claim extraordinary earnings exceeding by far fair and reasonable tariffs, resort to local courts for dispute settlement, dutifully observe contract commitments, and respect the regulatory framework.”<sup>71</sup>

The tribunal declined the jurisdiction to decide on the issue stating that the right to raise counterclaims has been resorted to by the Respondent States only to a limited extent in cases submitted to ICSID tribunals and the Respondent is not entitled to raise a counterclaim in such nature in this case.

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<sup>68</sup> *Sempra Energy International v. Argentine Republic*, ICSID Case No. ARB/02/16, Award, 28 September 2007, para 85.

<sup>69</sup> *ibid*, para 140.

<sup>70</sup> *ibid*, para 289.

<sup>71</sup> *ibid*, para 289.

#### **4.1.2. The Problems about the Treaty Interpretation and Raising Counterclaims**

After these two decisions, especially the first invocation of the legitimate expectations of the states in *Sempra* case, the possibility of asserting the legitimate expectation by the states needed to be addressed. There are some problems may rise from the current standards of investments protection and problem resolution methods.

The first problem derived from the wording of the articles in treaties and the interpretation rules of the investment treaties under Vienna Convention on Law of Treaties. Because there are no specific provisions considering the states' expectations, it is almost impossible to reach the conclusion that the states are entitled to have them by using the regular interpretation tools international investment law.

The investment treaties are interpreted by the Vienna Convention on the Law of Treaties Article 31.<sup>72</sup> The main method of interpretation is the "ordinary meaning" of the words. In a typical BIT, the legitimate expectations are not mentioned in the treaty but used as a component to determine the breach investment protection. There are only a few investment treaties that explicitly referred to the protection of legitimate expectations, and all of them limited to the scope of expectations only applicable to the investor. Therefore, within the ordinary meaning of the

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<sup>72</sup> "1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.

2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:

(a) Any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;

(b) Any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.

3. There shall be taken into account, together with the context:

(a) Any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;

(b) Any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;

(c) Any relevant rules of international law applicable in the relations between the parties.

4. A special meaning shall be given to a term if it is established that the parties so intended."

wording of the BITs and the other investment agreements, the states do not have the privilege of having legitimate expectations from the investors.

However, the new generation of the investment agreements includes provisions, references to international agreements or goals in the preambles about the environmental protection, human rights and sustainable development that create liabilities to the investors as well. States can claim to have legitimate expectations in connection with these implementations in the treaties.

Another problem arises from the fact that the states have a very limited opportunity to raise counterclaims, and almost no ground to raise counterclaims derived from treaty claims. Even though in recent arbitral awards, the tribunals took a more liberal approach for states to have counterclaims, it still has a very limited application<sup>73</sup>.

Traditionally, the states cannot invoke claims in the form of counterclaims seeking relief. The only possibility for the Respondent states to raise counterclaims by giving their position of the issue and defending its conduct; or aspiring to prove that the interpretation of the issues given by the Claimant is wrong. Under these circumstances, in current arbitration practice, the legitimate expectation claims may be raised by the host states should be related to the initial claims of the investor.

#### **4.2. Possible Claims of the Host States without Treaty Obligations**

The concept of legitimate expectations is closely related to the undertakings of the governments. States' conducts create reasonable and justifiable expectations on the part of an investor (or investment) to act in reliance on said conduct<sup>74</sup>. The legitimate expectations may arise from the investors' reliance upon the conditions established by the Respondent in the regulatory framework<sup>75</sup>. Governments' representations<sup>76</sup> and specific assurances by the host states as licenses, contracts<sup>77</sup>

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<sup>73</sup>For more information see: Hege Elisabeth Veenstra-Kjos, 'Counterclaims By Host States In Investment Treaty Arbitration' (2007) 4 Transnational Dispute Management.

<sup>74</sup> *Thunderbird v. Mexico*, para 147.

<sup>75</sup> *Enron v. Argentina*, para 265.

<sup>76</sup> *Metalclad v. Mexico*, para 89.

and in other forms of documents also factors that create legitimate expectations. Another notion that related to legitimate expectations considered by the tribunals is the importance of good faith as a general principle of law.<sup>78</sup>

Considering vice versa, the investors are always under the obligation of acting in good faith without exploiting the legal gaps may be found in the legal framework. Also, the investors may undertake some obligations and make promises about certain issues such as environmental protection or human rights. Especially the internal sustainable development policies and the projects that the corporations were involved is an indicator of commitment from the investor in matters environmental protection, labor rights or other measures of protection. Sustainable development<sup>79</sup> clauses in treaties create an opportunity for states to expect a certain behavior from the investors in investment protection. Without any treaty obligations specifically addressing the investors, commitments about sustainable development and environment issues become relevant with the treaty claims in several ways.

First of all, expectations of the states may be inferred from the preambles of the treaties. In recent investment agreements, the parties promote the environmental protection and sustainable development. For example in Japan–Switzerland FTA<sup>80</sup> it is stated that the countries are “determined, in implementing this Agreement, to seek to preserve and protect the environment, to promote the optimal use of natural resources in accordance with the objective of sustainable development and to adequately address the challenges of climate change” in the preamble.

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<sup>77</sup> Christoph Schreuer and Ursula Kriebaum, 'At What Time Must Legitimate Expectations Exist?', *A Liber Amicorum: Thomas Wälde* (1st edn, CMP Publishing 2009), p. 273.

<sup>78</sup> Florian Dupuy and Pierre Marie Dupuy, 'What To Expect From Legitimate Expectations? A Critical Appraisal And Look Into The Future Of The “Legitimate Expectations” Doctrine In International Investment Law', *Festschrift Ahmed Sadek El-Kosheri. From the Arab World to the Globalization of International Law and Arbitration* (1st edn, Kluwer Law International 2015), p. 278; Francisco Orrego Vicuña, 'Regulatory Authority And Legitimate Expectations: Balancing The Rights Of The State And The Individual Under International Law In A Global Society' (2003) 5 *International Law Forum*; *Thunderbird v. Mexico*, para 147.; *Sempra v. Argentina* para 299.

<sup>79</sup> Karl P. Sauvant and Güneş Ünüvar, 'Can Host Countries Have Legitimate Expectations?' (2016) 183 *Columbia FDI Perspectives*, p. 2.

<sup>80</sup> Agreement on Free Trade and Economic Partnership between Japan and the Swiss Confederation (signed 19 February 2009, entered into force 01 September 2009).

Also, the Norwegian Model BIT mentions explicitly in the Preamble that the parties desire to strengthen their economic and investment relations in accordance with the objective of sustainable development in its economic, social and environmental dimensions in a manner consistent with the protection of health, safety, and the internationally recognized labor rights<sup>81</sup>. EFTA- Colombia FTA<sup>82</sup> and Austrian Model BIT<sup>83</sup> also have a supporting language of sustainable development and environmental protection in their Preambles. Considering the interpretation methods given in VCLT, the preamble is a useful tool for the State to invoke the claim of legitimate expectations if an investor harms the environment and the objectives of sustainable development as a result of its conduct. Treaty interpretation regarding the object and purpose of the treaty gives the opportunity to adopt an approach that the investors are obliged to fulfill their promises and their violations of the host countries' regulations about the sustainable development may also be a violation of expectations of the host states.

Another specific representation of the investors could be the Corporate Social Responsibility (CSR). CSR is a business approach which aims to contribute to sustainable development in compliance with applicable law and consistent with international norms of behavior.<sup>84</sup> The majority of investment agreements, typically, do not refer to CSR; however, in recent agreements, the importance of the issue has been raised. Social responsibility started to be mentioned with acceleration in investment policies, and the inclusion of CSR clauses points to an increasing "legalization."<sup>85</sup> At the beginning of the 2000s, CSR clauses started to be seen in agreements. Over time, CSR clauses have become more elaborate regarding obligation and precision.<sup>86</sup> The parties use a stronger language in the statements about CSR regarding obligation stating that the parties shall observe and encourage social responsibility.<sup>87</sup> Canada has implemented promotion of social

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<sup>81</sup> Norway Model BIT, Preamble, Draft version 130515.

<sup>82</sup> EFTA–Colombia Free Trade Agreement, Preamble.

<sup>83</sup> Austria Model BIT, Preamble

<sup>84</sup> Guidance Standard on Social Responsibility, ISO 26000, published in 2010.

<sup>85</sup> Rafael Peels, 'Corporate Social Responsibility in International Trade And Investment Agreements' [2016] ILO Research Paper No. 13, p. 15.

<sup>86</sup> *ibid*, 16

<sup>87</sup> *ibid*, 16.

responsibility in FTAs with Colombia and Peru in provisions entitled as Corporate Social Responsibility specifically<sup>88</sup>.

A number of treaties refer international standards for responsible business conduct such as OECD Guidelines for Multinational Enterprises and United Nations Global Compact. OECD Guidelines aim to “strengthen the basis of mutual confidence between enterprises and the societies in which they operate, to help improve the foreign investment climate and to enhance the contribution to sustainable development made by multinational enterprises.”<sup>89</sup> Following the same pattern of objectives, UN Global Compact has ten principles related to human rights, environment, and labor issues. In the preamble of Austria Model BIT, OECD Guidelines for Multinational Enterprises stood as a model for responsible corporate behavior, and a way that can contribute to mutual confidence between enterprises and host countries.<sup>90</sup> EFTA-Colombia FTA<sup>91</sup> is an example of the agreements that highlighted the principles of corporate governance in the UN Global Compact.

Given the importance of the CSR policies, the investment made by one of the contracting parties indicates that the sustainable development and protection of the public health and environment is an issue requiring attention. The investors should be under the responsibility of not to harm the environment and respect the human rights protection, labor protection and any other obligations it is engaged by the CSR policies.

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<sup>88</sup> Canada-Peru Free Trade Agreement (signed 29 May 2008, entered into force 01 August 2009) **Article 810: Corporate Social Responsibility:** Each Party should encourage enterprises operating within its territory or subject to its jurisdiction to voluntarily incorporate internationally recognized standards of corporate social responsibility in their internal policies, such as statements of principle that have been endorsed or are supported by the Parties. These principles address issues such as labour, the environment, human rights, community relations and anti-corruption. The Parties remind those enterprises of the importance of incorporating such corporate social responsibility standards in their internal policies; similar language at Canada Colombia FTA (signed 21 November 2008, entered into force 15 August 2011).

<sup>89</sup> OECD (2011), OECD Guidelines for Multinational Enterprises, OECD Publishing.,p 13.

<sup>90</sup> Australia Model BIT, Preamble.

<sup>91</sup> EFTA–Colombia FTA, Preamble.

Investors' written commitments to host country governments may create legitimate expectations for the host states<sup>92</sup>. The tribunals in investment law accept the written commitments of the host state as a ground for legitimate expectations for the investors. For example in *Biwater Gauff v. Tanzania* case, the claimant signed three different contracts for the operation and management of water and sewage services after a bidding process. The operating company City Water which Biwater was a 51% shareholder, encountered problems and requested a renegotiation of the financial terms of the contract subsequent to the start of the operations<sup>93</sup>. The negotiations did not successfully go through, and the contract was terminated. Later on, Tanzanian government took control of the assets of the City Water and assigned a new management to operate the water services. The tribunal dismissed the claims for compensation due to the fact that there was no economic loss in relation to the expropriation had taken place. The tribunal relied on amici stating that the Claimant is the only responsible for these are failures. Furthermore, the claimant should have been aware of "the notorious state of financial and operational data on water systems in developing countries."<sup>94</sup>

In this case, the investment contract is ceased as a result of the investors' wrongful conduct. The Respondent state could have alleged to have legitimate expectations from the investor due to its written commitments in the contract.

### **4.3. Suggestions for Future Claims**

The host states expectations from the international investment agreements have started to shift. Instead of a mere economic contribution, the states demand contribution to developing an investment which is conscious of issues like environmental protection and human rights in return for "tying their hands in an international agreement<sup>95</sup>." On the contrary, in some cases, the investment

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<sup>92</sup> Sauvart, p.2

<sup>93</sup> *Biwater Gauff (Tanzania) Ltd. v. United Republic of Tanzania*, ICSID Case No. ARB/05/22, Award, 24 July 2008, para 82.

<sup>94</sup> *Biwater v Tanzania*, para 382.

<sup>95</sup> Wolfgang Alschner and Elisabeth Tuerk, 'The Role Of International Investment Agreements In Fostering Sustainable Development', *Investment Law within International Law: Integrationist Perspectives* (1st edn, Cambridge University Press 2013, p.29.

agreements have a negative impact on desired areas of protection. In today's investment world, not only the states but also investors should act responsibly and fulfill their obligations.

The states have started to take action to protect themselves against the claims of breaches of FET claims based on the legitimate expectations. In CETA for instance, in order to create a legitimate expectation, the parties should make specific representation to an investor to induce a covered investment that created a legitimate expectation<sup>96</sup>.

The first and obvious suggestion is the explicit recognition of the investor obligations in treaties in a manner to give the possibility to the host States has a right to raise claims of breach of legitimate expectations independently. The current aim of the system, provide protection to foreign investment, is changing at the moment. This particular addition could fit well into the current, ongoing paradigm shift from exclusive protection of investors towards establishing a more symmetrical legal system.

A milder approach of recognition of the legitimate expectations without a right to raise independent claims for the host state can be used for creating a balance between the parties and prevent the wide interpretation of the tribunals. Concepts such as contributory fault and investors' conduct give rise to the situation already accepted to diminish the amount of the compensation. There are steps taken, related to social responsibility, in some new generation, IIAs includes provisions about the responsibility of the both parties such as TPP<sup>97</sup>. Following that line, mutual recognition of legitimate expectations in investment treaties can bring balance to investment system and strengthen the investment regime's legitimacy<sup>98</sup>.

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<sup>96</sup> The Comprehensive Economic and Trade Agreement, Art 8.10

<sup>97</sup> Trans-Pacific Partnership Agreement, Article 9.17: Corporate Social Responsibility The Parties reaffirm the importance of each Party encouraging enterprises operating within its territory or subject to its jurisdiction to voluntarily incorporate into their internal policies those internationally recognized standards, guidelines and principles of corporate social responsibility that have been endorsed or are supported by that Party.

<sup>98</sup> Sauvart, p.2.

Another suggestion is to increase the number of IIAs mention the issues which give rise to legitimate expectations of the state. The states may invoke the legitimate expectations from the investors pursuant to their conducts implementing their social responsibility policies and their references to multinational instruments. The IIAs gave as examples stated above consist a minuscule number of investment agreements. In the traditional application of the BITs and other multilateral treaties, issues like sustainable development, corporate responsibility, and environmental protection are hardly mentioned. The increasing interaction between the international investment law and other fields of international law may encourage coherence between the different areas of international law. This facilitates the “systemic interpretation” approach in Article 31(3)(c) of the VCLT that takes into account other relevant rules of international law applicable between the parties.

#### **4.4. Concluding Remarks**

The possibility for host states to invoke legitimate expectations will contribute to the aim of the balancing policy between the states and the foreign investors. The states may have legitimate expectations using the same grounds as the investors. The expectations may rise from the written contractual commitments, multilateral undertakings or the other commitments like the CSR policies for the sustainable development.

The typical BITs are a lack of such provisions that gives the possibility for the host states to have legitimate expectations. From the angle of the VCLT interpretation tools, the opportunity to invoke expectations can be based on the Preambles that promoting sustainable development. If the investor does not comply with the protection measurements of the host states for the sustainable development, the states may claim a breach of the legitimate expectations. So far, some states in the arbitration process invoke the issue of the misconduct of the investors. These claims have not brought any success so far, but in the future, the companies’ conducts can be a legal basis for the tribunals to dismiss the investment protection claims on the ground of frustration of the legitimate expectations of the host state.

## **Chapter 5: Concluding Remarks**

The main intention of the investment arbitration system is to provide protection for the foreign investors. The investment treaties include several provisions to provide a standard of protection. However, “legitimate expectations” as a specific term of investment protection is not referred in most of the treaties. In arbitral awards and the scholarly opinions, the lack of specific definition of the concept can be observed. The tribunals accepted the legitimate expectations built on the arbitral jurisprudence and often applied it in a wide discretion. However, the enhanced standards of investor protection raise some concerns by the host countries. Especially the views are accepting that providing a stable regulatory framework by the host states as a legitimate expectation of the investors; makes harder for the host states to regulate in the matters of environmental protection or any other issues related to the public interests. Therefore, a balance between the states’ right to regulate and the protection of the legitimate expectation of the stable framework of the foreign investors must be accepted.

In an alleged violation of the indirect expropriation provisions, the tribunals applied the legitimate expectations of the states as one of the many aspects to decide whether an indirect expropriation occurred. In cases regarding the investors’ claims that the change of regulations of the host state frustrated their legitimate expectations, the tribunals took two different approaches. While some tribunals offer a strict protection to the investors’ legitimate expectations in every circumstance; the others applied a standard that is more tolerant to the states’ right to regulate to adapt the changing conditions relating the public interest, i.e., the protection of environment, human health or culturally and naturally protected areas. Also, the specific commitments made by the host states to provide a stable legal environment have increased the level of protection applied by the tribunals.

Cases related to the FET standards, the tribunals attributed a certain importance to the specific commitments of the host states in order to decide a breach of legitimate expectations. The measures exceed the normal regulatory powers beyond the acceptable margin of change has admitted as a frustration of the legitimate expectations; apart from that in the absence of the explicit or implicit

promises to provide a legal framework, a mere regulatory change that causes economic loss to the investor is not a violation of the expectations. The tribunals tried to redress the balance between exercising regulatory rights of the state and the legitimate expectations of the investors by investigating the explicitness of the commitment.

The various approaches taken by the tribunals to balance the interests of the parties, does not change the nature of the one-sided protection to give to the foreign investors. The states started to expect more from the investors' operation in their economies especially in the areas of sustainable development and environmental protection. Moreover, the host states defend that the actions taken by the investors lead them to regulate in a certain area or took measurements that may have an adverse impact on the investment. Under these changing circumstances of the investment law, the asymmetric protection has become insufficient balancing the legitimate expectations of the investors and host states' right to regulate.

The endeavor to balance between the investment protection and the legitimate expectations may also be achieved by recognizing the right to invoke legitimate expectations to the host states. In *Sempra v. Argentine* case, the first invocation of the legitimate expectations made by stating that the government has expectations for an investor to act in good faith and not to claim extraordinary earnings taking advantage of the reasonable tariffs. Following that line of thought, the host states can expect the investors to conduct their businesses in a manner that respectful to the regulations of the state. The legitimate expectations of the states can be deduced from the Preambles of the treaties and the specific undertakings of the investors. Especially in the cases that the investors have specific commitments, the natural outcome for the host states to expect the administration of the investment by it. The specific commitments can be stem from the contractual obligations e.g. to follow the environmental regulations or from the CSR policies that are declared to be followed in the conduct of the investment.

The problem with states invoking legitimate expectations is that the current treaty protection is not compatible with such claim. The investment treaties do not contain provisions to provide the right of raise claims for the investors. However,

in the absence of such explicit language, the host states may still plead the legitimate expectations from the investor by asserting the Preambles of the treaties that promotes the sustainable development of both parties to the dispute.

Recognizing the host states' legitimate expectations can serve as a breath of fresh air considering the application of different standards to the concept of legitimate expectations. The regulations of the states in the time of investment was made can serve as a basis for the legal framework, and in cases of the violations of the legal framework, both parties to the dispute can claim legitimate expectations. In this way, while the investors can give legitimate expectation that the framework will not change, states may also find an anchor for the unjustified claims of the investors which violate the legal framework relating the issues such as sustainable development which was already accepted by the investor at the beginning of the investment process.

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