Report on Panel 3: How to strike a balance between the protection of investments and the host country's right to regulate

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In his introduction, **Antonio R. Parra** first noted that this question was at the heart of substantive rules on the treatment of foreign investments. It concerned the shielding of foreign investments from the impact of subsequently adopted measures, while respecting the host state's undeniable right – or rather, duty – to regulate and control such investments. The challenge was to find an appropriate balance between regulating and protecting investments and adequately to serve both of these purposes.

Crina Baltag focused on stabilization clauses and their use by investors to ensure the stability of the regulatory framework surrounding their investments.

Dr. Baltag started by briefly describing how stabilization clauses had evolved over time from the highly criticized *general* freezing stabilization clauses, which, insofar as they prevented the host

state from enacting laws that could affect the investment, were perceived as infringing on a state's legislative sovereignty, to *specific* freezing stabilization clauses, applicable to specific matters such as tax, and finally, to stabilization clauses that were intended not to infringe the state's sovereign right to regulate but to shield investments from regulatory changes by preventing host states from imposing such changes on investors.

Dr. Baltag then described the essential features of various recent stabilization clauses. She mentioned intangibility stabilization clauses, which prohibit unilateral modifications to a contract and require the consent of both parties; renegotiation clauses, which provide for the renegotiation of the contract in cases where the host state adopts measures affecting the economic benefits of the original bargain subsequent to its conclusion; and allocation of burden clauses, which are a feature of contracts with state-owned companies and place the burden of regulatory changes by the host state on the state-owned company rather than on the foreign investor.

Dr. Baltag then considered how arbitral tribunals in investment arbitration have dealt with stabilization clauses and concluded that, while tribunals recognize a state's right to exercise its sovereign legislative powers, they generally consider stabilization clauses to give rise to legitimate expectations under the Fair and Equitable Treatment ("FET") standard, meaning that a breach of the clause would constitute a breach of the FET under the applicable investment treaty.

In her concluding remarks, Dr. Baltag noted that "new generation" investment treaties grant supplemental powers to states to deal with matters of public interest, particularly in the fields of human rights, health and environment, and she urged tribunals to strike a better balance between the public interests of the state and its citizens and the private interests of the investor.

Mahmoud M. Elkhrashy addressed the question of how arbitral tribunals in investment arbitration have in practice balanced investment protection and the host country's right to regulate when applying or interpreting FET clauses in investment treaties.

He started by recalling the doctrine of state police powers as articulated in the 1987 Restatement (Third) of US Foreign Relations Law, according to which "[a] state is not responsible for loss of property or for other economic disadvantage resulting from bona fide general taxation, regulation, forfeiture for crime, or other action of the kind that is commonly accepted as within the police powers of states, if it is not discriminatory," and that such police powers are enshrined in international treaties, customary international law and arbitral awards.

He then raised concerns over the move by some arbitral tribunals to encroach upon the realm of state police powers by broadening the scope of certain aspects of the FET standard, such as the protection of the investor's legitimate expectations and the stability of the legal framework of an investment. He warned that this could have the effect of freezing governmental policy, crippling the host state's ability to adopt legislative reforms, and even preventing the host state from fulfilling some of its international obligations (e.g. with respect to environmental, health, or labor matters) out of fear of being ordered by arbitral tribunals to pay damages to investors.

Mr. Elkhrashy then examined the interaction between the state's police powers and the FET standard and, more particularly, to what extent the foreign investor was entitled to expect that the legal framework surrounding its investment would remain unchanged. He identified three approaches in the practice of investment arbitral tribunals that had examined the issue. The first approach was to consider whether the investor's legitimate expectations lay in the mere existence of a particular legal framework at the time of the investment, any modification of which would constitute a breach of the FET standard. The second, more restrictive, approach was to require a

specific representation by the state vis-à-vis the investor (e.g. a stabilization clause or a unilateral specific undertaking). The third approach took into account all relevant circumstances and specificities of a case, such as the extent of the changes to the legal framework governing the investment, the state's level of development, and whether the changes discriminated against the investor.

In conclusion, Mr. Elkhrashy recommended that, when negotiating (and renegotiating) investment agreements or treaties, policymakers should emphasize the state's regulatory rights and define the precise content and scope of the FET provisions. He urged arbitral tribunals to adopt a more balanced approach that would protect the investor without encroaching on the state's regulatory rights.

Francisco González de Cossío then addressed how arbitral tribunals have balanced the protection of investments with a host state's right to regulate when applying or interpreting expropriation provisions in investment treaties.

Dr. González de Cossío recalled that, traditionally, particularly under national laws, expropriation was understood as the 'deprivation of property' carried out by the executive authority of the state via a transfer of title to the benefit of the government. International law had expanded the concept of deprivation of property to include as expropriation the mere (albeit substantial) lessening of the value of an investment, as opposed to the complete transfer of property.

Dr. González de Cossío then questioned whether the current and broader notion of expropriation under international law really hindered the state's police powers. Referring to the reasoning of the ICSID arbitral tribunal in the highly controversial *Philip Morris v. Uruguay* case and other cases of alleged expropriation, he noted that, when examining allegations of regulatory expropriation,

arbitral tribunals were likely, first, to examine whether the state had the power—or even the duty—to adopt the relevant regulatory measure; second, to consider the state's underlying aim in adopting the relevant measure; third, to address whether the relevant measure was proportionate, taking into consideration not only the state's interest in regulating but also the investor's interest in maintaining an unaltered legal framework for its investment; and fourth, to examine whether or not the relevant measure was discriminatory. In performing this exercise, states were accorded a margin of maneuver to tackle social problems as they saw fit.

In conclusion, Dr. González de Cossío observed that a regulatory measure could result in indirect expropriation when a state's exercise of police powers leads to substantial deprivation *and* fails to meet certain requirements. However, bona fide, legitimate, proportionate, non-discriminatory regulatory measures adopted in the public interest would not result in expropriation. Accordingly, the argument that investment law hinders a state's policing rights lacked foundation.

Finally, **Alexander Uff** examined the different ways in which "new generation" investment treaties attempted to strike a balance between the protection of investments and the host state's right to regulate.

Using a series of examples taken from recently concluded investment treaties and various model treaties, Mr. Uff discerned at least six different mechanisms that states had used to promote the right to regulate in investment treaties:

- The first mechanism was to carve out particular fields of regulation from the application of certain investment protections under the treaty. Article 21 of the 2012 US Model BIT is an example of this common form of carve-out. It provides that, except in relation to expropriation, the treaty's protection standards are inapplicable to taxation measures. Mr.

Uff observed that such carve-outs had not prevented investment tribunals from assessing whether state actions constituted bona fide taxation measures, or from finding breaches of other treaty standards, such as FET, where they did not.

- The second mechanism was similar to the first, but excluded the application of the entire treaty (rather than specific protection standards) from classes of regulatory measures. An example of this is the 2017 Colombia Model BIT, which excludes the application of the treaty to taxation, public debt operations and to measures related to the financial sector taken for reasons of prudence. As with the first mechanism, it could be argued that a tribunal should assess whether or not a state's measures fall within the exclusion.

- The third mechanism was to specify in the treaty text how its protection standards should be understood. An example is Article 8.10.2 of the 2017 EU-Canada Comprehensive Economic and Trade Agreement ("CETA"), which lists criteria that may qualify as a breach of FET. Mr. Uff noted that it does not, however, mention items such as the breach of legitimate expectations or the assurance of a stable business environment, which are considered to form part of the FET standard in many investment treaty awards.

- The fourth mechanism was to include in the treaty text an explicit statement affirming a state's right to regulate, as in Annex B of the 2012 US Model BIT, Article 9.16 of the 2016 Trans-Pacific Partnership, and Article 8.9 of CETA. The US Model BIT's affirmation of the right to regulate applies to non-discriminatory action to protect "legitimate public welfare objectives." Mr. Uff commented that this type of affirmation arguably raises the threshold for regulatory action to qualify as a violation of the treaty standard and also ensures that the right to regulate is part of the argument in an arbitration.

- The fifth mechanism was again to expressly affirm a state's right to regulate, but to add an explicit reference to proportionality in assessing regulatory action, as in Annex 11B of the 2012 US-Korea Free Trade Agreement. Mr. Uff described proportionality as an analytical tool investment tribunals use to assess state regulatory actions by considering the legitimacy of the regulatory interest which a state seeks to protect and by balancing the method of regulation against the degree of interference with the interests of the investor.

- The sixth mechanism was to include an express reference in an investment treaty to international human rights instruments, as in the preamble to the Austria-Kazakhstan 2012 BIT. This reference could be relevant to, and have a potentially significant impact on, the interpretation of the provisions of the treaty in accordance with Article 31 of the 1969 Vienna Convention on the Law of Treaties.

Mr. Uff noted that most of the mechanisms he had identified were yet to be tested in disputes. He opined, however, that arbitral tribunals would still be likely to assess whether disputed measures were bona fide regulatory actions. He said that the fact that the balance between protection of investments and the host state's right to regulate was being debated should be seen as a sign of the good health of the investment arbitration system and that the system was capable of self-regulation, but he cautioned against "using a sledgehammer to crack a nut."