At a glance

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CETA: Investment and the right to regulate

Under international public law, states can be asked to compensate investors whenever regulatory measures become expropriation measures or violate standards of treatment, such as the 'fair and equitable treatment of investors' obligation. The EU-Canada Comprehensive Economic and Trade Agreement (CETA) takes a relatively restrictive approach to these investor rights.

Background

Rules on international investment law aim at providing a balance between the host state's right to expropriate or to legislate, and foreign investors' right to their property and to a certain standard of protection (non-discriminatory treatment, access to justice, etc.). One of the main issues in the debate over CETA has been whether investment protection rules may affect the capacity of states to regulate. The right of investors to claim compensation for regulatory measures emerges in two main instances: in the context of indirect expropriation claims, and in that of claims of violation of the fair and equitable treatment (FET) obligation.

Two main investor claims linked to regulatory measures

Indirect expropriation

In international law, expropriation is only legal if it is in the public interest, compliant with due process, non-discriminatory, and subject to compensation. Regulatory measures can have a similar effect to expropriation; in such cases, investors can bring claims based on indirect expropriation. Interpretations by tribunals, concerning what constitutes indirect expropriation, have varied. On the one hand, some tribunals define illegitimate indirect expropriations only on the basis of a sole-effect doctrine, requiring proof of a 'substantial deprivation' of the right to property (*AES* v *Hungary*, *LG&E* v *Argentina*). On the other hand, tribunals have engaged in a balancing exercise between state interests and impact on investors' rights, taking into account the public purpose of the measure, the bona fide nature of the measure (in terms of transparency, non-discrimination and non-arbitrariness), and also the proportionality of the measure (*Fireman's Fund Insurance Company* v *United Mexican States*).

The legitimate expectations of investors have been taken into account in indirect expropriation claims. Here too interpretation has varied. Under the broader interpretation, an expectation can be considered to arise from the simple status quo of the regulatory environment at the time the investment was made, i.e. the investor's expectation, without any state promises or actions, that the regulatory environment would not change. This broad interpretation of investors' legitimate expectations means that the political risk of changing the regulatory environment is not borne by the investor. The second, more restrictive, interpretation makes the legitimate expectation subject to effective representation made to the investor by the host state. Examples are contractual obligations included in a contract or the existence of a specific commitment between the host state and the investor. Alternatively, a previously existing legal measure might have mentioned the attraction of investment as its purpose. A famous example of legitimate expectation backed by government assurances is the *Metaclad* case: the Mexican government had given assurance to *Metaclad* that its project complied with environmental standards but then, in response to local opposition, the municipality refused the construction permit.

Fair and equitable treatment

While 'national treatment' and 'most-favoured nation treatment' rules ensure non-discrimination relative to the treatment received by other investors, the fair and equitable treatment (FET) principle establishes a standard of protection for investors without the need to reference treatment given to other groups. The scope of FET remains vague, covering both substantive and procedural rights. These include the right to due process,

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the right to access to justice, protection against arbitrariness and discrimination, the requirement of transparency, and other concepts of good governance, such as a stable and predictable legal framework.

With respect to the principle of a stable and predictable legal framework, FET has been associated with an obligation not to frustrate the legitimate expectations of investors. Here too, there are various approaches. The **first** is based solely on the concept of ensuring a stable legal and business framework. A **second**, more restrictive, interpretation requires a specific representation to have been made by the state, including contractual obligations set out in a contract or the existence of a specific commitment between the host state and the investor (*Methanex v United States*), or mention in a legal measure, before amendment, of the purpose of attracting investment (*Enron v Argentina*). A **third** interpretation, presented in an UNCTAD paper, makes the legitimate expectation claim subject to further qualifying requirements. This approach, found in the *Duke Energy v Ecuador* case, requires proof of the following elements to find a breach of legitimate expectations: legitimate expectations may arise only from a state's specific representations or commitments to the investor, on which the latter has relied; the investor must be aware of the general regulatory environment in the country and expectations must be reasonable, and founded on the political, socioeconomic, cultural and historical conditions prevailing in the state; and, lastly, investors' expectations must be balanced against the legitimate regulatory activities of the host country.

CETA and the right to regulate

CETA introduces in Article 8.9 a provision reaffirming the **right to regulate**. The formulation of this provision is different from a similar provision negotiated in the OECD's draft multilateral investment agreement. The latter required a state's regulations to be consistent with its obligations under the treaty, in other words the right to regulate did not justify violations of obligations under the treaty. CETA does not adopt this *a contrario* approach and instead establishes a positive right, specifying that the mere fact of changing a law, adversely affecting the parties' expectations (of profits for example), does not amount to a breach of an investment protection obligation.

The CETA approach to indirect expropriation clearly favours the **balancing approach**, which requires that consideration be given to the economic impact of the measures, the nature of the government action and the extent to which a government action affects expectations, but also to the non-discriminatory nature of legitimate public welfare actions. Expectations are further specified as 'distinct, reasonable investment-backed expectations' that have been interpreted as unambiguous commitments by the host state.

The approach adopted by the EU in CETA, as well as in the EU-Singapore agreement, aims to define the content of the FET obligation clearly. Reference to the changing concept of international customary law is dropped. The article provides an **exhaustive list of actions that violate the FET principle**. CETA requires the parties to review the list regularly. Had the list of violations been open-ended, no revision would have been required, as new additional violations not explicitly included in the list could have been added directly by tribunal award. Instead, further breaches can only be added to the list by decisions of the CETA Joint Committee. The FET obligation does still make reference to **legitimate expectation** (see CETA Article 8.10(4)). However, the concept is linked strictly to the idea of **specific representation made by the state** to induce the investor to make the investment. The investor must be able to prove that the state made a specific representation of this kind to induce the investment, that the investor relied on such a representation in making the investment decision, and that the state frustrated that expectation. This definition codifies the existing case law, choosing the restrictive interpretation approach. The legitimate expectation claim is further limited by the article on the regulatory right of the state (CETA Article 8.9), where it is clarified that the mere fact of a change to a law that adversely affects the investors' expectation does not amount to the breach of an obligation.

CETA has been criticised from two distinct angles. On the one hand, while authors acknowledge the more precise drafting, it has been claimed that CETA leaves too much flexibility. The 'right to regulate' does not imply that compensation cannot be claimed for a legitimate measure having equivalent effect to a proper expropriation, and other definitions (such as that for legitimate expectation) would still leave some discretion. On the other hand, by introducing more specificity and codifying existing arbitral practices in an attempt to emphasise state rights, some scholars see CETA as still reverting to the traditional asymmetric view of investment law, while blurring the limits between investor rights and state obligations. At the same time, both of these trends contribute to the fact that international investment law should aim to strike a balance between the rights of two parties, the rights of the investor and the rights of the state, and that like any legal rule, it should allow sufficient flexibility to cover any situation that may arise under the law.