Exploring the Approach Against Problem of Legitimate Expectations Under the Fair and Equitable Treatment Standard by Host States

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Abstract. This essay discusses the challenges associated with the definition of legitimate expectations in host-state dispute settlement. The concept of legitimate expectations requires the government to respect citizens' expectations of policy continuity and stability based on legal principles and has become a self-standing doctrine in international investment contracts. However, the lack of clarity in interpretation and diligence on the part of the host nation has resulted in inconsistent outcomes in similar situations, undermining legal certainty. Additionally, the longstanding defense of legitimate expectations has weakened the host country's authority to regulate. The essay provides recommendations, including recognizing the factors that give rise to legitimate expectations, operating in an open and transparent manner, scrutinizing informal representations of governmental intent, and instituting a reasonable response program to avoid liability for necessary government actions.

Keywords: Legitimate Expectation; FET; Host States.

1. Introduction

The number of investment contracts between nations has increased dramatically since the first agreement between Germany and Pakistan for the development and conservation of investment. With economic globalization, a growing number of disputes between foreign investors and host nations have arisen. In investor-state dispute settlement, the Fair and Equitable Treatment (FET), particularly the definition of legitimate expectations, has become a self-standing doctrine. However, despite its theoretical benefits, there are several practical issues associated with legitimate expectations.

One of the primary problems is the lack of clarity in the explanation of the element of meeting the legitimate expectations of investor. The arbitral tribunal's broad interpretation of this concept has resulted in inconsistent outcomes in similar situations, which undermines legal certainty. Another major problem is the lack of diligence on the state of the host nation in considering the factors that give rise to legitimate expectations. For example, they may lack diligence when dealing with investors' legitimate expectations triggered by investment contracts, leading to inconsistent behavior between government departments related to the same investment contract. Additionally, the arbitral tribunal's longstanding defense of the legitimate expectations of investors has weakened the host country's authority to regulate. Arbitral tribunals frequently prioritize the legitimate expectations of investors over the reasonableness of changes in the host government's law, which can result in the host state having insufficient control over state sovereignty or the public interest.

This essay identifies these problems and offers suggestions. The first section of the paper defines legitimate expectations and applies a typology based on four factors - investment contracts, laws and regulations, government actions, and informal expressions of intent - to explain what gives rise to legitimate expectations and how to recognize them. The second section focuses on the three difficulties mentioned above. The third section provides recommendations, including ensuring that host nations operate in an open, transparent, and consistent manner to avoid problems caused by a lack of diligence, scrutinizing informal representations of governmental intent to restrict the legitimate expectations that arise from them, and instituting a reasonable response program to avoid liability for necessary government actions.

2. Nature of Legitimate Expectation Under FET

2.1. What is Legitimate Expectation?

The nature of legitimate expectations first appeared in administrative law in the National Energy case. This concept requires the government to respect citizens' "reasonable expectations", which means that the law must safeguard stability based on legal principles, trust in policy continuity, and the legitimate expectations and related interests that arise from policies or administrative actions [1]. These expectations can be either procedural or substantive. These principles have their origins in the UK and France and have been applied in the international investment sphere in recent years.

Investors make investment decisions based on their anticipated investment returns. These expectations are established by assessing the legal situation and pros and cons of the policies of the target country. Consequently, investors' expectations form the foundation for investment decisions. Although some scholars hold that the definition of legitimate expectations is distinct from the FET principle, the most prevalent scenario involves arbitral tribunals determining that the host country has infringed legitimate expectations under the explanation and application of the FET [2]. Currently, most theoretical discussions regarding these principles are based on analyzing typical arbitral cases or citing directly the interpretations of specific cases by arbitral tribunals.

The court in the Tecmed v. Mexico case explained the concept of reasonable expectations of investors as stipulated in Article 154 of the award. This principle, which has been frequently cited by other tribunals in various cases, holds that the host country must provide foreign investors with treatment that does not violate their primary expectations when making an investment. The principle is based on the international law principle of good faith, and it is not applicable to the investors according to the Tecmed court.

The court also clarified that in order for foreign investors to understand the host country's laws, legal system, policies, and other provisions, the host country must act in a consistent, unambiguous, and fully transparent manner. This will allow investors to plan their investments and make informed decisions. The host country must not change its policies arbitrarily or without notice, as this will leave the investor unable to assess the treatment and protection offered by the host country.

Consequently, the principle of reasonable expectations has gained traction in the area of international investment. Furthermore, it is now seen as a crucial factor in determining the criteria of fair and equitable treatment in a number of treaty arbitration decisions involving foreign investors and host countries.

2.2. What Can Lead to Legitimate Expectations?

The causes of legitimate expectations are a primary and difficult problem. Legitimate expectation is an element under FET which, due to the abstract and vague expression of FET in practice in various treaties, lacks clear and concrete guidelines for academic study. Legitimate expectations arise for a variety of reasons. In a narrow sense, legitimate expectations are based solely on special commitment given by the host government. In contrast, the broader causes are investment contracts, laws and regulations, governmental acts and informal representation of intent. The causes of legitimate expectations should be explored in a typology.

2.2.1 The investment contract

An agreement outlines specific duties and entitlements and serves as the most direct written proof of the parties' intentions. Among written contracts, investment contracts are formal actions by the host nation and are the most likely to generate investor dependence. Since a contract constitutes a definite pledge with distinct legal ramifications, the anticipations it generates should be safeguarded [3]. In MTD v. Chile, the Malaysian investor reached an investment agreement with the Chilean Foreign Investment Commission (FIC) to erect a sizeable, planned community. The tribunal stressed that the contract on its face mirrored the investor's legitimate expectations. Chile violated the FET requirement of the BIT by engaging in "inconsistent actions by two branches of the same government

with respect to the same investor." In Continental Casualty v. Argentine case, the arbitrators remarked that the Argentine government's independent revision of its obligations should be scrutinized. It is a fundamental principle that the tribunal should examine the context, justifications, and repercussions of such revisions and safeguard the legal rights and expectations arising from the agreement [4].

It is essential to acknowledge that, in general, legitimate expectations under an investment agreement are not the same as legitimate expectations under a FET provision. Furthermore, the thwarting of a contractual expectation per se does not amount to an infringement of the fair and equitable treatment standard under treaties [5,6]. However, as a specific commitment by the host State, the investment contract provides some basis for the legitimate expectations and is an important tool for assessing legitimate expectations under FET obligations.

2.2.2 Laws and regulations

Laws and regulations are critical factors in determining the risks and rewards of investments. Before committing their capital, investors typically examine a country's laws and regulations, which form a foundation for their expectations. It is unreasonable for a country to fundamentally reject or frustrate these expectations. For instance, in the NAFTA of International Thunderbird Gaming Corporation v United Mexican States, the United Mexican States banned gambling on Mexican territory under the Federal Gaming and Sweepstakes Act and established Mexican laws governing the regulation and authorization of gambling establishments [7]. Arbitral tribunals have noted that these laws and regulations bind investor expectations as part of the due diligence investors should undertake, demonstrating the important impact of a country's laws and regulations on investor expectations. In a more straightforward case, Teemed v. Mexico, the arbitral tribunal considered the stability and predictability of the host country's laws and regulations to be a necessary requirement for reasonable expectations [8].

Nonetheless, scholars argue that it is necessary to re-balance the legitimate expectation of investors against the legal powers of the host state. Investor expectations do not encompass freezing the host country's legal system. Changes in the laws of the host country are a risk that investors should anticipate [9]. In the case of South American Silver v Bolivia, the tribunal stated that FET did not preclude the government from adapting its legislation to meet changing social needs [10]. Similarly, in EDF Services Ltd v Romania, the tribunal noted that apart from special commitments or statements made by the State to the investor, the investor may not rely on the BIT as an insurance policy combating the risk of alternation in the legal and economic structures of the host State [11].

2.2.3 Governmental acts

When an investor bases their investment on a formal government decision or permit, the legal rights stemming from such a decision or permit cannot be arbitrarily revoked or modified. In these cases, it is rational for the investor to expect that the official government decision or permit is not subject to arbitrary revocation or modification. Arbitral tribunals typically uphold such expectations positively. For example, in both the CME v. Czech Republic case and the Ronald Lauder v Czech Republic case, the arbitrators held that cancelling prior arrangements or revoking a previously granted permission by a state agency could constitute a infringement of fair and equitable treatment since such express permission might form a legitimate expectation on the state of the investor [12,13].

2.2.4 Informal representation of intent

Legitimate expectations can arise from informal indications of intent, but they may be overlooked by host states due to their informal nature. This can lead to different perceptions of legitimate expectations between host countries and investors, which can ultimately cost the host country in arbitration. Scholars have identified several categories of informal representations, including (1) the existence of an investment contract alongside informal representation, (2) the investor's use of informal representation to support the contractual commitment, (3) both parties invoking informal representation in addition to guarantees provided by foreign investment regulations, and (4) unilateral informal representation [14].

In arbitration, the formal nature of the governmental act is not necessarily a determining factor. Informal forms of commitments, reports, guidelines, and other actions made by public authorities within the scope of their powers may be considered legally binding and unable to be arbitrarily revoked. These informal representations can be used to establish reasonable expectations by investors. For instance, in Southern Pacific Properties Ltd. v. Arab Republic of Egypt, the tribunal noted that informal conduct by Egyptian officials, such as Presidential Decree No. 75, may be legally invalid or susceptible to invalidation. However, foreign investors rely on these acts as they are communicated with governmental authority and may rely on informal representations made by senior government officials in the host country, such as in Egypt [15].

3. How to Recognize the Legitimate Expectations?

Recently, the arbitration practice has reached a consensus that protecting investors' legitimate expectations is a component of FET, but there is no clear standard for recognizing these expectations. Tribunals typically consider when and why an investor's expectations should be deemed legitimate. The arbitration practice has identified the range of legitimate expectations from previous cases. For example, in Loan Micula et al v. Romania, the claimants argued that Romania's withdrawal of investment incentives after joining the European Union violated their legitimate expectations [16]. The tribunal supported the majority of the claimants' arguments, holding that the government could not simply terminate the incentive program. However, co-arbitrator Abi-Saab disagreed and argued that an investor's legitimate expectations must be based on a legal commitment from the government. In Parkerings-Compagniet AS v Lithuania, the court established standards for identifying the legitimacy of investors' expectations regarding the stability of the legal system. In Glamis Gold v United States, the court held that the failure to fulfill expectations created by the host government to attract investment constituted a violation of FET under NAFTA1105(1) [17,18].

Therefore, determining whether investors' expectations are legitimate must be based on cases and consideration of all relevant factors. Due to the abstract nature of "legitimate expectation," it is challenging to provide an exact definition; instead, it can only be studied based on the particular circumstances of each case. To achieve an objective and proper decision, all relevant factors must be considered. Professor Walder of the University of Dundee suggests that the criterion of FET should include the following: the protection of legitimate expectations of investment combined with the transparency principle, the principle of good faith, and the ban on violation of power and tyranny [19]. Furthermore, a breach that constitutes an investor's legitimate expectation must meet specific requirements: (1) the expectation must originate from the host state's promise, (2) the investor must trust the host state's promise and act accordingly, (3) the change by the host state is unforeseeable, and (4) the host state's behavior that impairs the investor's legitimate expectation leads to actual harm to the investor, and the burden of proof for demonstrating the presence of legitimate expectations and the resulting loss falls on the investor.

4. Problems Under Legitimate Expectation Encountered by Host States

4.1. Lack of Diligence about Performance Leading to Legitimate Expectations

As the causes of legitimate expectations analysed above, the host states’ conduct in the face of these causes has often led to many problems through inappropriate or imprudent behaviour. Practice and arbitration cases show that host states sometimes lack the necessary care in their conduct in response to legitimate expectations. The key is to clarify the problem in a typological manner in order to propose solutions to the problem. This article identifies problems and analyses them in the context of contractual breaches, informal expressions of intent and conduct based on alternation in law in the host state.

4.1.1 Contractual breach

Based on the preceding discussion, an investment contract is a formal agreement between a foreign investor and the host state regarding the investment and its treatment. The arbitral tribunal places great importance on the legitimate expectations of the investor that is based on a specific investment contract, rather than the formal or informal representations made by the host government. The investor's expectations under the investment contract are given the highest priority by the tribunal in terms of the need for protection. In cases where the host State breaches the investment contract, this may also constitute an infringement of the FET obligation. For instance, in MTD v. Chile, the host State was held liable for the inconsistent conduct of two government departments relating to an investment contract [20]. The host country may also fail to exercise due diligence and neglect sectoral and policy coordination with respect to the investment contract.

Furthermore, another issue to consider is whether the imprudent conduct of the host state in relation to the investment contract has resulted in a violation of FET liability. In the case of Parkerings v. Lithuania in 2007, the government of Vilnius reached a "contract for the establishment of a parking management system" with a foreign investor, which led to a dispute between the parties. The tribunal's interpretation of the legitimate expectations under the investment contract was that not every "hope" of the investor qualifies as an "expectation" under the investment law [21]. In other words, a breach of the investment contract by the host state does not automatically equate to a violation of international law. The host state must distinguish between "expectations" under the contract and those under the FET obligation in cases where there has been a contractual breach due to the imprudent conduct.

4.1.2 Informal representation of intent

The challenge for the host State lies in addressing the issue of legitimate expectations that arise from informal indications. The issue is whether and to what extent informal indications can give rise to legitimate expectations on the part of the investor. The SPP v. Egypt and Sempra v. Argentina cases demonstrate that the actions of government officials, warranties, or representations can create legitimate expectations [22,23]. The host State's conduct in diplomatic matters lacks clear criteria for the level of diligence required. Imposing an overly strict standard to avoid liability may unreasonably restrict diplomatic means, hindering the development of international investment. Along with the aforementioned cases, PSEG v. Turkey saw a dispute arise from an investment promotion policy enacted by the host State; Frontier Petroleum v. Czech Republic saw ministerial correspondence posing a risk; and White Industries v. India saw statements by government officials leading to a dispute [24-26]. Informal representations of intent are particularly broad and complex. This directly leads to the fact that different types of informal indications in the above cases produce separate legal effects. Clear criteria are needed to determine the level of diligence required in the conduct of informal representations of intent.

4.1.3 Governments conduct based on alternation in the law

Based on the analysis of practical cases, it can be concluded that legitimate expectations do not imply a freeze on legislation, and general legislative changes do not usually breach specific commitments made to investors. Most arbitral tribunals have not recognized such changes as frustrating investors' legitimate expectations. However, this does not mean that the host state's conduct based on changes in the law is not subject to any constraints. Host states should fulfill basic procedural justice obligations and mitigate negative impacts on investors to the extent possible. The tribunal in Arif v. Republic of Moldova emphasized that investors' rational and legitimate expectations include the protection of their procedural expectations [27]. Although legislative changes may be based on sound public policy considerations, investors should be protected by due process, and the host state should be able to mitigate the impact. The MTD v. Chile case also illustrates that the host state may have a duty of policy coordination, and the breach of this duty could lead to liability under the FET [20].

However, the tribunal did not provide specific criteria for determining when a general legislative change constitutes a frustration of investors' reasonable expectations. Arbitration practice is not consistent as to when and to what extent a change in general legislation is an acceptable and reasonable level of change in line with the principle of proportionality. This problem can only be left to the discretion of the tribunal to determine on an ad hoc basis, which may lead to uncertainty in the consequences of governments' conduct.

4.2. Regulatory Chill for the Host States

Because of the blind protection of legitimate expectation of investors under investment treaties and arbitration practices, host states often find themselves in a dilemma of "regulatory chill", where their right to regulate is ignored and damaged over time.

In general, host states exercise control in two ways [28]. Firstly, they may change the behavior of their government after the investor has completed their investment, thereby disappointing the legitimate expectation of the investor based on the commitment made by the host state, resulting in a loss of interests for the investor. Secondly, changes to the legal or objective environment of the host state may occur. If the host government changes or repeals existing laws arbitrarily, investors who rely on such laws and the environment will suffer. Legitimate expectation is a basis for claimants to seek relief in the investment arbitration, primarily used to protect the interests of investors. If the behavior of the host state creates legitimate expectations for the investor (or the investment), and the investor (or the investment) acts accordingly, but the host state is unable to fulfill the expectations due to the need for public interest, it may lead the investor (or the investment) to frustrate their legitimate expectations. FET does not emphasize serious interference with or harm to the interests of the investor's property, but rather whether the host state's conduct meets the criteria of FET. In practice, producing objective criteria for judging the host state's behavior is challenging, and the concept of "fairness and justice" is abstract and unclear, putting the host state's control right at a disadvantage in international investment tribunal. Sometimes, when the legitimate expectation of investors is met, the host state's political pressure, economic crisis, institutional changes, and other factors may be overlooked, leading to a challenge to the host state's control power [29]. The host state's control over national sovereignty or public interest may be too limited, resulting in an adverse impact on national interests.

5. Suggested Approach to Deal With the Potential Liability Under Legitimate Expectation of FET

5.1. Application of Reasonable Measure with Transparency and Efficiency

The use of government measures is an effective means of safeguarding the sovereignty of host states. However, as discussed earlier, the behavior of governments in dealing with changes in investment contracts and laws is often lacking in diligence. To address this issue, this article proposes that the implementation of measures must consider three key elements: reasonableness, transparency, and effectiveness.

Firstly, it is important to maintain sovereignty while ensuring that legislative and administrative measures are reasonable and do not become arbitrary. This provides investors with a stable legal environment and enhances the country's investment climate, making it more attractive for long-term investment. The conduct of the government based on legal measures can be characterized as retroactively altering the law, making sudden or secretive changes to the law, engaging in unjustified government action, not complying with legislative objectives, exhibiting inconsistency, lack of continuity or clarity, and creating a roller-coaster effect through ongoing legislative changes or radical changes to pre-existing legislation that cannot be justified. In the Toto v. Lebanon case, the tribunal stated that "when alternations in law and regulation drastically or discriminatorily alter the essential character of an investment transaction, the host state may be deemed to have breached its obligation

under fair and equitable treatment to investors." Arbitral tribunals often perceive sudden and significant changes in the law of the host state as a violation of the legal environment. Although it is difficult to develop criteria to guide the conduct of host states in practice, it is clear that government decisions should be based on the law and not be arbitrary. The law in host states should provide a level of certainty and prohibit arbitrariness while avoiding frequent changes that disrupt planning.

Secondly, the host state should act in an open, transparent, and consistent manner. The behavior of the host state is the factual basis and logical starting point for analyzing the legitimate expectations of investors. In the MTD v. Chile case, discrepancies in the conduct of different authorities in the host state and the failure to fulfill the obligation to coordinate policy changes led to a breach of the investment agreement and liability under the FET. When the host state's conduct affects its obligations under the investment agreement, it should communicate openly and transparently with the investor in a timely manner to coordinate the influence of the policy change. The host state's approach should also be proactive and prudent.

5.2. Rigorous Scrutiny to the Governmental "Informal Expressions of Intent"

"Informal expressions of intent" are frequently used in investment promotion diplomacy by host countries, but the legitimate expectations resulting from them are often disregarded. While arbitration cases have drawn attention to this issue, unclear criteria make it challenging for host countries to determine the appropriate level of diligence. This article argues that the legitimate expectations arising from "informal expressions of intent" should be limited, and that the host state should be strict in its conduct when it comes to commitments, declarations, and other acts.

In the first place, the attribution of "informal expressions of intent" should be restricted. While an investment tribunal will not deny the presence of a legitimate expectation of an investor simply because of informality, a governmental act lacking specificity and relevance is insufficient to create an expectation that the government will maintain its commitments in the future. As seen in cases such as Paso v. Argentina and Frontier Petroleum v. Czech, unclear and imprecise "informal expressions of intent" are hardly a basis for a tribunal to determine that the reasonable expectations of the investor have arisen and to impose liability. The specific criteria for determining the legitimacy of such expectations were identified in cases, for examples: Sempra v. Argentina and Glamis Gold v. USA [18]. The "purpose principle" has been supported by arbitral tribunals, which suggests that the host government, through its informal representations, may have created an "objective expectation" with the intention of inducing foreign capital. However, it requires the host government to engage in active inducement, creating a "quasi-contractual expectation." Additionally, as demonstrated in the International Thunderbird Gaming Corporation v. Mexico case, a "legal opinion document" is not sufficient to make a legitimate expectation that the investor will acquire and operate gaming machines in Mexico [7]. Therefore, "informal expressions of intent" should be specific and definitive.

Secondly, host states should also be strict in their commitments, declarations, and other acts. Informal expressions of intent, such as policy statements, unilateral declarations, promises, and guarantees made by the host state, may be the basis for a foreign investor to claim legitimate expectation protection. Although the attitude of arbitral tribunals has been inconsistent in individual cases, the general trend has been to grant investors the protection of legitimate expectations. In addition, general statements made by political leaders, such as the representation of the head of state in various public forums or general declarations encouraging foreign investment, may also lead to a legitimate expectation claim. The specificity and certainty of the conduct should be taken into account. Prudent conduct will enable the host state to avoid potential obligations or claims while attracting investment.

5.3. A Rational Response Programme Against Claim

5.3.1 Urgent and necessary measures

In times of political, economic, or social crises, a state may take urgent and necessary measures that could potentially influence the interests of foreign investors, though these measures were not

specifically targeted at them. To safeguard foreign investors and minimize risks arising from a State's actions, Bilateral Investment Treaties (BITs) often incorporate necessity clauses that consider the interests of the host State. This necessity clause makes the host government avoid negative consequences resulting from a breach of its obligations. By invoking the necessity clause, the host state can defend itself against liability in certain circumstances.

The LG&E Energy Corp v. Argentina case illustrates how the Tribunal recognized the government's response to the economic crisis as necessary and practicable to maintain public order and protect national security interests [31]. Consequently, as long as the measures taken by the host government are necessary in the given circumstances and do not go beyond the limit of necessity, the host state can use the defense of necessity to exempt itself from certain liabilities. This means that certain political risks resulting from the investment project and affecting investors are exceptions to the investment agreement.

5.3.2 Investor due diligence

Investors have a responsibility to perform due diligence on a state's regulatory framework to assess legitimate expectations, as recognized under the FET [32]. In some cases, courts have required that due diligence is conducted by the investor in order for their expectations to be deemed reasonable and therefore protected. For instance, in the case of Stadtwerke Munchen and others v. Spain, the court held that an expectation of investor must be based on a rigorous due diligence procedure [33]. Conversely, in Antaris v. Czech Republic, the investor's claim for the protection of legitimate expectations was denied because of the lack of evidence of any actual due diligence [34]. Likewise, in Belenergia v. Italy, the court thought that the investor's due diligence reports did not cover management risks related to the specific tariffs [35]. The tribunal noted that a diligent investor would have examined Italian laws and regulations related to PV and incentives, which suggested a clear trend towards reduction. Thus, the due diligence performed by the investor was deemed not sufficient.

Based on these cases, a host state can respond to a claim of legitimate expectations by arguing that the investor did not conduct adequate legal and regulatory due diligence before deciding their investment. The host state can provide evidence of previously specified development plans, as well as other reasons and facts, to show that the investor's due diligence was insufficient [36].

6. Summary

This paper outlines the definition of legitimate expectations and the factors that give rise to them, including investment contracts, laws and regulations, government actions, and informal expressions of intent. The paper also discusses how to recognize legitimate expectations and then delves into several issues related to them. One problem is that tribunals have broadly defined legitimate expectations and imposed few restrictions on their protection, leading to inconsistency in their internal requirements for host states to maintain legal stability. Another issue is that host states often fail to perform due diligence when faced with conditions that generate legitimate expectations. This can be seen in cases as MTD v. Chile and PSEG v. Turkey, where different types of informal expressions of intent have different legal effects. Additionally, arbitral tribunals tend to prioritize investors' legitimate expectations over the reasonableness of alternations in the law of host state, eroding the host nation's right to regulate.

To address these problems, the paper recommends several measures. Firstly, host nations should ensure that their legislative and administrative procedures are reasonable, transparent, and consistent to minimize problems resulting from a lack of diligence. Secondly, informal representations of government intent should be scrutinized to limit the legitimate expectations they generate. Finally, by adopting a fair claims response strategy, breaches of legitimate expectations arising from necessary basic government measures can be avoided.

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