TRACING POLITICAL DETERMINANTS OF FET STANDARD AND DUE DILIGENCE OF INVESTORS IN INVESTOR-STATE DISPUTE SETTLEMENT

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ABSTRACT

Investor-state dispute settlement has proven to be a complex process, primarily because of the labyrinthine nature of high-stake commercial disputes under bilateral investment treaties. Globalization has revitalized the phenomenon called foreign direct investment. Concomitantly, the jurisprudence on fair and equitable standard found in bilateral treaties has paved the way for a more coherent understanding of such disputes, especially when there are no concrete definitions of vocabulary used in customary international law. This article discusses one aspect that predominantly affects the odds of investors getting the fair and equitable treatment - the political determinants prevalent in the host State. Limiting its scope to four particular political determinants, the article further attempts to analyse the trend of approaches adapted by tribunals in interpreting the interplay of politics and bilateral investment treaties.

Introduction:

The ever-evolving landscape of inter-state dispute settlement governs the regime of foreign direct investments and international investment laws. With a large number of States allowing nearly hundred percent foreign direct investment, the mechanisms to protect investment in foreign nations become even more significant, so as to regulate the approaches of States against investors. Concomitantly, investor-state arbitration has proven to be a complex process, primarily because of the labyrinthine nature of high-stake commercial disputes under bilateral investment treaties. Lack of precise definitions in customary international law makes the interpretations vulnerable to being too liberal, and exposes the vocabulary to the risk irregular construction of meaning, differing on a case-to-case basis. An instrumental standard to protect the rights of investors in such claims is the fair and equitable standard of treatment. This paper discusses one aspect that predominantly affects the odds of investors getting the fair and equitable treatment - the political determinants prevalent in the host State.

A. Meaning of FET Standard:

Fair and equitable treatment standard (hereinafter "FET standard") is a standard of treatment accorded to foreign investors, commonly found in almost all bilateral investment treaties, and yet there is no one agreed upon definition of what this treatment constructively entails. The determination of a general meaning of FET standard is very critical in claims of expropriation of investment by host states, because it attributes violation of treaty to the host state, subsequently making the states responsible for compensation under customary international law.

While there is consistency maintained by arbitral tribunals in interpreting FET standard, interpretations largely depend upon the text of the treaty and contextual intricacies of a dispute. Therefore, the implementation of FET standard may vary without constraining its meaning to an exhaustive definition. The quest for finding a homogenous definition of FET standard becomes even more complicated when the FET clause is intertwined with other clauses in investment agreements, such as 'minimum standard of treatment' and 'full protection and security' clause.

However, as the OECD report[1] suggests, FET standard can be defined as following: "The phrase "fair and equitable treatment", customary in relevant bilateral agreements, indicates the standard set by international law for the treatment due by each State with regard to the property of foreign nationals. The standard requires that – subject to essential security interests – protection afforded under the Convention shall be that generally accorded by the Party concerned to its own nationals, but, being set by international law, the standard may be more exacting where rules of national law or national administrative practices fall short of the requirements of international law. The standard required conforms in effect to the "minimum standard" which forms part of customary international law."

Thus, evidently, there are various components that constitute a fair and equitable treatment. In order to comply with the FET standard, it is expected that the host States will provide the investors with a politically stable environment. Political situations govern the acts of a state. Concomitantly, they also govern the compliance of a host state with FET standards. Arbitration tribunals, ICSID tribunals specifically, have followed a somewhat similar approach in rendering judgements regarding whether or not a political determinant breaches FET standard, thereby according the investors protection against the state actions. One factor however, that chiefly dictates the outcome of a claim is due diligence conducted by investors prior to the time of investment.

While there are numerous procedural and substantive aspects of FET standard, this article will primarily focus only on political determinants that affect the standard. It will also emphasize the need to carry a proper due diligence on the basis of a few representative cases. The focus will be on four political determinants that may affect FET standard; namely- i. Change in policy of the government, ii. Statements of political leaders iii. Change in government and iv. Discrimination by States.

B. Political Determinants and FET Standard: A Sui Generis Nexus of Rights and Liabilities:

There is plethora of regulatory facets that create turbulence in a political discourse; which in turn affect the investments. Amongst them, the following four have attracted a substantial

[1] OECD (2004), "Fair and Equitable Treatment Standard in International Investment Law", OECD Working Papers on International Investment, 2004/03, OECD Publishing. http://dx.doi.org/10.1787/675702255435 Page 10

amount of scrutiny in arbitral jurisprudence.

I. Change in Policy of the Government:

A stable legal and business environment is an essential element of fair and equitable treatment.[2] In case of a sudden shift in policy, the motives of current government play a requisite role. In assessing reasons for the shift, tribunals look into the proportion of action taken and its nexus with reasons for such actions. In the landmark *Vivendi*[3] judgement, the tribunal recognised two things. First, that even when a predecessor government has granted certain concession to the investors based on a desire to rescind or re-negotiate, the successor government, under the FET standard, is bound to continue the concession, without disparaging it. And second, that a newly introduced governmental policy, camouflaged as a regulatory activity, the inception of which is motivated by politically driven arm-twisting aimed at compelling Claimants to agree to new which were acceptable to the new government, clearly violates the FET standard.[4]

The second point of issue regarding change in policy is what happens to an investment if it is approved by the state against the policy of the state itself. The onus of proof thereby shifts on the State. The *MTD*[5] case, presented a similar scenario to the tribunal. The issue in the case was of unfair treatment by the State when it approved an investment against the policy of the State itself. In its decision, the tribunal rendered that such approval itself is unreasonable and unacceptable under FET to begin with.[6]

Moreover, a lack of proper procedure or policy towards the investors can result in breach of FET standard. In *Metalclad*, the fact that no procedure was in place for dealing with building permit application given to claimants showed that Mexico failed to ensure a transparent and predictable framework for investor's business planning and investment.[7] The tribunal further noted that the totality of matter demonstrated a lack of orderly process and timely disposition in relation to an investor of a party acting in the expectation that it would be treated fairly and justly in accordance with the NAFTA.[8]

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[2] CMS Gas Transmission Company v. The Republic of Argentina. ICSID Case No. ARB/01/8, (May. 12, 2005).
[3] Vivendi Universal S. A. v. Argentine Republic. ICID Case no. ARB/97/3 Paragraph 7.4.39
[4] Vivendi Universal S. A. v. Argentine Republic. ICID Case no. ARB/97/3 Paragraph 7.4.37
[5]MTD Equity Sdn. Bhd. And MTD ChileS.A. v. Chile, ICSID Case No. ARB/01/7, Arbitration ruling, May 25, 2004
[6] *Id*. at 5
[7] Metalclad Corp. v. United Mexican States, ICSID Case No. ARB(AF) /97/1, Award, August 30, 2000
[8] *Id.* at 7

The scope of what constitutes a governmental action or the action attributable state is supremely broad. Actions of States include actions of legislative, judiciary and executive. There is no inconsistency regarding this approach, as the tribunals interpret governmental action to include actions of these three organs.

II. Statements of Political Leaders:

Political statements of leaders, more often than not, play a part in shaping the way an investment is perceived. This could have effects on enterprise of the investors, and the goods and services offered by such enterprises. In *Biwater*[9], the tribunal emphasized on the fact that the Republic's public statements at this time constituted an unwarranted interference in investment related dispute. Further, the tribunal noted that these statements inflamed the situation, and polarised public opinion.[10]

A very broad canvas of facts was considered in the approach taken by the tribunal in *Rankin.*[11] It was held that even statements of Iranian revolutionary leaders were inconsistent with customary international law minimum standard of treatment. Broadening the definition of acts attributable to the State, it was said that the act of an insurrectional movement which becomes the new government of a State shall be considered an act of that State.

III. Change in Government or Administration

When it comes to investment being affected by change in government or administration, there is a multiplicity of approaches adapted by the tribunals over the last few decades.

In *Thunderbird,*[12] the tribunal rendered that the closure of investor's business as a result of outlawing the business activity by new administration is not arbitrary. In *Tecmed*[13], renewal of permit was denied to the investors. The tribunal affirmed, that the reasons that prevailed denial of renewal of the permit were reasons related to the social or political circumstances and the pressure exerted on municipal and state authorities. Therefore, to determine whether such denial deprived the rights of investors, the tribunal considered whether community pressure

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[9] Biwater Gauff (Tanzania) Ltd v. United Republic of Tanzania. ICSID Case No. ARB/05/22, (Jul. 24, 2008).
[10] Biwater Gauff (Tanzania) Ltd v. United Republic of Tanzania. ICSID Case No. ARB/05/22, (Jul. 24, 2008). Para 627
[11] Jack Rankin v. The Islamic Republic of Iran, IUSCT Case No. 10913 (Award No. 326-10913-2) - 3 Nov 1987
[12] International Thunderbird Gaming v United Mexican States, UNCITRAL. Arbitral Award, 26 January 2006
[13] Técnicas Medioambientales Tecmed, S.A. v. United Mexican States, ICSID Case No. ARB (AF)/00/2, Award, May 29, 2003

and its consequences, were so great as to lead to a serious emergency situation, social crisis or public unrest, in addition to the economic impact of such a government action, which in this case deprived the foreign investor of its investment with no compensation whatsoever. More tellingly, it was stated that in order to assess the proportionality of governmental action, these factors must be weighed. International breach can thus be caused by *outrage, bad faith*[14]*, wilful neglect of duty, or an insufficiency of governmental action so far short of international standards that every reasonable and impartial man would readily recognize its insufficiency.*[15]

Contradictorily, in *Genin*,[16] the tribunal found that there was no breach of FET taking into account the fact that the claimants had knowingly chose to invest in: "a renascent independent state, coming rapidly to grips with the reality of modern financial, commercial and banking practices and the emergence of state institutions responsible for overseeing and regulating areas of activity perhaps previously unknown."

Evidently, political change is not a decisive criterion unto itself. Its interpretation in the framework of FET standard heavily relies on the facts of the dispute.

IV. Discrimination against Investors:

The Merriem Webster[17] dictionary defines the word discrimination to mean following three things:

1. Prejudiced or prejudicial outlook, action, or treatment.
2. Act, practice, or an instance of discriminating categorically rather than individually.
3. Act of making or perceiving a difference.

Under international law, there is no singular definition of discrimination. Discrimination in bilateral treaties is almost always embodied in the legitimate expectations of investors, national treatment clause and most-favoured-nation treatment clause.

[14] Glamis Gold Ltd. v. United States, [Award], Ad hoc—UNCITRAL Arbitration Rules, NAFTA, June 8, 2009
[15] Neer
[16] Alex Genin, Eastern Credit Limited, Inc. and A.S. Baltoil v. The Republic of Estonia, ICSID Case No. ARB/99/2
[17] Merriam Webster Dictionary, https://www.merriam-webster.com/dictionary/discrimination, last visited 02.08.2023

A very inclusive definition was developed by tribunal in *Saluka*[18]. It was recognised, that under principles of international law, a foreign investor protected by the treaty may expect that conduct of host State does not manifestly violate the requirements of consistency, transparency, even-handedness and non-discrimination. In particular, any differential treatment of a foreign investor must not be based on unreasonable distinctions and demands, and must be justified by showing that it bears a reasonable relationship to rational policies not motivated by a preference for other investments over the foreign-owned investment.[19]

Arbitrariness, however, cannot be weighed in isolation. *Eureko*[20] award enunciates that a breach of fair and equitable treatment can been determined due to actions not for cause but for purely arbitrary reasons linked to the interplay of politics and nationalistic reasons of a discriminatory character. Furthermore, tribunal in that case found discriminatory intent to be an important factor.[21] Yet a non-discriminatory change for formal purpose could be allowed and does not constitute a breach of FET standard.[22] Arbitrary pressure on foreign investors[23] and unjust treatment is unacceptable from the international perspective.[24]

C. Due Diligence of Investors:

One loophole, if left unsealed, could result in exponential loss of investment in foreign States as well as the loss of opportunity to claim compensation. It is the lack of due diligence on the part of investors. Before an investment is made, it is vital that due diligence is carried, so as to know the existing conditions in the host States. Diligence of existing conditions also makes it possible to anticipate the changes in the future. Excluding arbitrary changes in situations that could not have possibly foreseen before (these include natural calamities and mala-fide governmental actions), due diligence can give a reasonably decent idea as to security of

[18] Saluka Investments BV (The Netherlands) v. The Czech Republic, Arbitration under the UNCITRAL Arbitration Rules, The Netherlands-Czech Republic BIT, Partial Award, March 17, 2006

[19] *Id. at 18*

[20]Eureko B.V. v. Republic of Poland, Ad Hoc Arbitration, The NetherlandsPoland BIT, Partial Award, August 19, 200

[21] S.D. Myers, Inc. v. Government of Canada, [NAFTA] Arbitration under the UNCITRAL Arbitration Rules, Partial Award, November 12, 2000

[22] AES-Tisza ErömüKft. v. Hungary, ICSID Case No. ARB/07/22—Energy charter treaty, Arbitration ruling, September 23, 2010; Chemtura Corporation v. The Government of Canada, Arbitration under UNCITRAL, NAFTA Arbitration Award, August 2, 2010; Spyridon Roussalis v. Romania, (ICSID Case No. ARB/06/1), Greece - Argentina BIT, Award, December 7, 2011

[23] CME Czech Republic B. V. (The Netherlands) v. The Czech Republic, (2006) 9 ICSID Rep 264, (2006) 9 ICSID Rep 412, (2003) 15(4) World Trade and Arb Mat 83, IIC 62 (2003), (Mar. 14, 2003)

[24] *Id. at 21*

investment.

The "due diligence" is nothing more nor less than the reasonable measures of prevention which a well-administered government could be expected to exercise under similar circumstances.[25]

In *Asian*[26], the tribunal found that the words full and constant added to strengthen the required standards of "protection and security" could justifiably indicate the Parties' intention to require within their treaty relationship a standard of "due diligence" higher than the "minimum standard" of general international.[27] This denotes reciprocity of obligations, in that, for an investor to expect full protection and security, the due diligence should be invariably done prior to asking for such protection.

Similarly, in *Methanex*,[28]the tribunal held that the regulatory and political environment may be a factor that the investor should take into account, and to anticipate regulatory change in areas where high levels of regulation can be foreseen, unless the host country has given assurances that no regulatory changes will take place.

Comments of tribunal in *Parkerings Compagniet*[29] on the conundrum of internal sovereignty of States and due diligence are worth noting here, since rights of a State also include the ability create laws and regulations in their sovereign capacity. These provide clarity as to extent of government's power to regulate internal matters that affect investments. The observations leave no ambiguity regarding the standard of security given to investors, and further distinguishes arbitrary state actions from the reasonable ones.

"It is each state's undeniable right and privilege to exercise its sovereign legislative power. A state has the right to enact, modify or cancel a law at its own discretion. Save for the existence of an agreement, in the form of a stabilisation clause or otherwise, there is nothing objectionable about the amendment brought to the regulatory framework existing at the time an investor made its investment. As a matter of fact, any businessman or investor knows that laws will evolve over time. What is prohibited however is for a state to act unfairly, unreasonably or inequitably in the exercise of its legislative power. The investor will have a

[25] Asian Agricultural Products Ltd. v. Republic of Sri Lanka. ICSID Case No. ARB/87/3, (Jun. 27, 1990).
[26] *Id. at 25*
[27] *Id* at 25; Paragraph 50
[28] Methanex v. United States, UNCITRAL, Final Award on Jurisdiction and Merits
[29] Parkerings-Compagniet AS v. Lithuania, ICSID Case No. ARB/05/8, Award, September 11, 2007

right of protection of its legitimate expectations provided it exercised due diligence and that its legitimate expectations were reasonable in light of the circumstances. Consequently, an 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."

Thus, there are two requirements before an investment is made – investor's due diligence and reasonable expectation of stability based on due diligence. An omission or reckless regarding due diligence could result into investor's claims for loss of investment not being entertained by tribunals.

D. State Responsibility:

The extent of state responsibility depends on synthesis of facts from various point of views. In *Waste Management*,[30] it was laid down that,

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

States have responsibility to take measure tat ensure that full protection and security is accorded to the investment. Therefore, an omission to take such steps can make the host States liable to pay compensation.[31] It's the role of States to comply with the bilateral investment till the moment the investment remains in the territory.

Furthermore, State responsibility cannot simply be decided by a purely objective approach. As noted in various judgements,[32] the dispute as a whole, and not extracted, isolated events determines whether there has been a breach of international law.

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[30] Waste Management v. United Mexican States (II). ICSID Case No. ARB(AF)/00/3, (Apr. 30, 2004)
[31] American Manufacturing & Trading, Inc. v. Republic of Zaire, ICSID Case No. ARB/93/1 Para 6.11
[32] PSEG v. Turkey, Award, 19 January 2007, para. 245; GAMI v. Mexico that." (Final Award, 15 November 2004, para. 97

E. Concluding Notes: A Brief Analysis of the Trend

While the cases mentioned above are neither binding nor representative of a broad canvas of investor-state disputes, they do in fact provide for a framework regarding the approaches taken by tribunals. What is strikingly notable, is the consistency and regularity of approach taken by tribunals. FET standard confers certain rights and duties on the investors and host states respectively, thus making the standard intricately complicated and invariably effective in deciding these claims. The cases noted above are persuasively significant as they are extensively referred to by the tribunals.

FET standard maintains a proportionate sense of check and balances. For example, it allows for the policy change to take place but refrains such change if it is unreasonable and arbitrary. Without curbing a state's right to rule on its internal matters, it also ensures that the legitimate expectations of investors are met. In regards to political change, it is to be noted, that all the decisions mentioned above place emphasis on two things. First, that the political atmosphere should not arbitrarily convolute the conditions favourable to investment and second, that before making the investment, it is obligatory for investors to thoroughly envisage the predictable conditions without making myopic assumptions. Furthermore, after the investment is made, the politicians of host state are unallowed to indirectly create an atmosphere of hostility towards the goods and services provided by the investment. Concomitantly, an interplay of politics and nationalism cannot facilitate discrimination against investors. Even with a lack of proper definitions, tribunals have maintained a uniform way of interpretation and reasoning.

Investor-state arbitration has taken an interesting shape pursuant to the cardinal phenomenon of globalization. It has created avenues for investors around the world to expand their reach, which in turn contributes in economic growth of a nation. With bilateral treaties, this transaction is protected from abuse or exploitation of either party. Fair and equitable treatment facilitates the realisation of this goal. For a harmonious system of foreign direct investments, it is thus critical to locate and control the political determinants that prolifically affect the FET standard.