

# EX POST GENERAL REGULATION AND INVESTMENT PROTECTION IN RECENT INTERNATIONAL ARBITRATION

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## SÍNTESIS

Varios tribunales de arbitramento internacionales constituidos en virtud de Tratados de Protección a la Inversión han adoptado recientemente decisiones relacionadas con la expedición, por parte de Estados, de nuevas normas legales que han afectado en forma negativa a inversionistas extranjeros. El artículo define el término “normatividad nueva” en un sentido general que comprende las siguientes situaciones: (i) la adopción, por parte de Estados receptores de inversión, de nuevas normas dirigidas a solucionar graves crisis económicas y que afectan relaciones contractuales previamente establecidas con inversionistas extranjeros; (ii) la expedición, por parte de dichos Estados, de normas ulteriores que lesionan los intereses de inversionistas extranjeros con quienes aquellos no tienen relación contractual alguna; (iii) la falta de aplicación, por parte de Estados receptores, de legislación vigente al momento de efectuarse la inversión extranjera; y (iv) el cambio ulterior de interpretación de la normatividad con claro perjuicio para inversionistas foráneos.

Todas estas circunstancias tienen una faceta en común: la legislación vigente al momento en el cual el inversionista extranjero hizo su inversión no produce los efectos que este esperaba. El artículo analiza como los tribunales de arbitramento internacional han resuelto estas situaciones y presenta las lecciones que tanto Estados receptores como inversionistas extranjeros pueden extraer de los correspondientes laudos.

**DESCRIPTORES:** Protección a la Inversión, Arbitramento Internacional, Expedición de Nueva Legislación.

## ABSTRACT

Some international arbitration tribunals under various bilateral investment treaties (BITs) have recently dealt with the issue of ex post general regulations adopted by host States, which have adversely affected foreign investors. An ex post regulation is understood here in a broad sense and comprises the following situations: (i) host States' enactment of new legislation for emergency reasons, which alters previous contractual relations with foreign investors; (ii) host States' adoption of ex post regulations affecting foreign investors with whom they lack a legal relationship; (iii) host States' ex post lack of enforcement of regulations existing at the time of the making of the investment; (iv) host States' ex post change of the interpretation of existing regulations, adversely affecting foreign investors.

These situations all have a common feature: the regulation existing at the time that the foreign investors made their investment is not applied according to its terms. The article illustrates how arbitration tribunals have ruled in each of the above-mentioned circumstances and the lessons that both host States and foreign investors can learn from the awards.

**DESCRIPTORS:** Foreign investment, Internacional Arbitration, Ex Post Regulation.

Some international arbitration tribunals under various bilateral investment treaties (“BITs”) have

recently dealt with the issue of ex post general regulations adopted by host States that have adversely

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affected foreign investors. An ex post regulation is understood here in a broad sense and comprises the following situations:

1. Host States' enactment of new legislation for emergency reasons, which alters previous contractual relations with foreign investors.
2. Host States' adoption of ex post regulations affecting foreign investors with whom they lack a legal relationship.
3. Host States' ex post lack of enforcement of regulations existing at the time of the making of the investment.
4. Host States' ex post change of the interpretation of existing regulations, adversely affecting foreign investors.

These situations all have a common feature: the existing regulation at the time that the foreign investors made their investment is not applied according to its terms. The way international arbitral tribunals have resolved the disputes could shed some light on how both States and investors could proceed before and

after the adoption of any of these forms of new regulation, despite the fact that the controversies differ in terms of facts and underlying treaties.<sup>1</sup>

Generally speaking, the set of international awards that will be analyzed below reveal, first, that foreign investors' rights are preserved even in the case of grave economic crises that force States to adopt ex post regulations affecting these rights; second, that host States possess ample power to adopt ex post regulations that negatively affect investors with whom there is no legal relationship; third, that host States would be declared internationally responsible for lack of enforcement of their legislation only under very limited circumstances, although the possibility exist; and finally, concerning ex post changes of interpretation of extant legislation, recent arbitral jurisprudence has had slightly different approaches. One international award sided with the foreign investors due to the lack of legal stability embodied in the change, while another held that host States' good faith in adopting the change freed them from international responsibility.

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<sup>1</sup> The purpose of this article is to analyze the awards from the perspective of ex post regulation only. Thus, the comprehensive evaluation of the entire controversies and the whole set of issues evaluated by the given arbitration tribunals is beyond the scope of this article.

**I. EX POST REGULATIONS  
 ADOPTED TO RESOLVE  
 ECONOMIC CRISES,  
 INVESTORS' CONTRACTS,  
 AND THE AWARD IN *CMS  
 GAS TRANSMISSION  
 COMPANY v. THE  
 ARGENTINE REPUBLIC*<sup>2</sup>**

Waves of economic crises in emergent economies occur from time to time and pose significant risks for foreign investors already operating there. Although host States and investors develop instruments to manage and attenuate this risk, such instruments may still be insufficient in the face of severe economic slowdowns and depressions. The *CMS* tribunal dealt with the impact that Argentina's crisis at the end of the last decade and the measures Argentina adopted to solve it had on an American investor. While at least one previous NAFTA Chapter 11 award, as will be seen below, had judged a State's behaviour in light of its severe economic crisis to conclude that, because of the crisis, along with other factors, the behaviour could not be considered arbitrary and contrary to the fair and equitable treatment principle, the *CMS* tribunal produced a more

balanced solution: investors' rights must be preserved even under these critical circumstances, although they must also bear some of the burdens associated with such crises.

**A. *The Facts of the CMS Dispute***

The dispute involved CMS Gas Transmission Company ("CMS"), a company constituted under the laws of the State of Michigan, and the Argentine Republic regarding measures the latter adopted to deal with the grave economic and social crises the country faced at the end of the 1990s. The measures were considered by CMS as infringing on the 1991 Treaty between the United States and the Argentine Republic Concerning the Reciprocal Encouragement and Protection of Investment.

The origin of CMS investment in Argentina dated back to 1989, when Argentina adopted economic reforms aimed at privatizing public utilities, among many other industries, and at attracting foreign capital.<sup>3</sup> The cornerstones of the reforms were three legal instruments: Law No. 23.696 on the Reform of the State of 1989, Law No. 23.928 on Currency Convertibility of 1991, and Decree

<sup>2</sup> *CMS Gas Transmission Company v. the Argentine Republic*, ICSID Case No. ARB/01/8. May 12, 2005 [hereinafter *CMS award*]. (Members: Francisco Orrego, Marc Lalonde, and Francisco Rezek). Available at [http://www.worldbank.org/icsid/cases/CMS\\_Award.pdf](http://www.worldbank.org/icsid/cases/CMS_Award.pdf).

<sup>3</sup> See *id.* ¶ 53.

No. 2128/91 fixing the Argentine peso at par with the U.S. dollar.<sup>4</sup> Regarding the gas industry, the legal framework was set by Law No. 24.076 of 1992, the Gas Law, which set the rules for the transportation and distribution of natural gas, which were implemented by Decree No. 1738/92, known as the Gas Decree.<sup>5</sup> As a result of the privatization policy embodied in the above-mentioned norms, Transportadora de Gas del Norte (“TGN”) was created, in which investors were allowed to participate by means of a public tender offer.<sup>6</sup> TGN was granted a licence for 35 years by Decree No. 2457/92, on the basis of the Model Licence embodied in Decree No. 2255/92.<sup>7</sup> In 1995, CMS acquired 29.42% of TGN’s shares from the Argentine government.<sup>8</sup>

According to CMS, the legal framework and TGN’s licence constituted the following guarantees for TGN, which became the subject of the dispute: (i) tariffs were to be estimated in US dollars; (ii) conversion to Argentine pesos would take place at the time of billing; and (iii) tariffs would be adjusted each six months according

to the United States Producer Price Index (“PPI”).<sup>9</sup>

Argentina’s economic crisis appeared at the end of the last decade, and one of the measures Argentina adopted to sort out the crisis was that it negotiated with the gas companies to suspend the PPI adjustment for six months during the first semester of 2000. It was also agreed that the companies would recoup the losses during the second semester until April 2001.<sup>10</sup> Specifically, the parties understood that this agreement would not modify the legal regime of the licenses.<sup>11</sup> Given the impossibility of restoring the PPI adjustment, the Argentine government and the companies reached a second agreement suspending the PPI adjustment for two years, until June 30, 2002, when it would be introduced it again. Decree No. 669/2000 contained this agreement and explicitly recognized that the U.S. PPI adjustment was “a legitimate acquired right” and a basic condition of the tenders and offers.<sup>12</sup> Decree No. 669 was suspended by a federal judge, so Argentine authorities were

4 *See id.*

5 *See id.* ¶ 54.

6 *See id.* ¶ 55.

7 *See id.* ¶ 56.

8 *See id.* ¶ 58.

9 *See id.* ¶ 57.

10 *See id.* ¶ 60.

11 *See id.*

12 *See id.* ¶ 61

prevented from applying it, and the U.S. PPI adjustment remained frozen from January 1, 2000, on.<sup>13</sup>

As the economic crisis deepened, provoking political upheavals that led to the appointment of successive presidents within weeks, Argentina enacted Emergency Law No. 25.561 on January 6, 2002, introducing significant changes to the foreign exchange system. The Argentine currency was not longer pegged to the U.S. dollar; the peso was devalued; and both the U.S. PPI adjustment and U.S. dollar calculation of tariffs were abolished. Tariffs were redenominated in pesos at the rate of one peso to the dollar.<sup>14</sup> Argentina put in place a Renegotiation Commission to renegotiate licences, but no agreement was reached with gas transportation and distribution companies.<sup>15</sup>

According to CMS, the main effects of the Argentine measures on TGN were the following: a 75 percent drop in tariff revenue, a significant increase in costs and a default of certain dollar-denominated

obligations.<sup>16</sup> CMS alleged that, as a consequence of the measures, the value of its investment in TNG had been reduced by 92 percent from U.S. \$261 million to U.S. \$17.5 million.<sup>17</sup> In sum, CMS claimed damages for U.S. \$261 million plus costs and interest.<sup>18</sup>

CMS then claimed mainly that Argentine measures had expropriated its investment without compensation, thereby infringing Article IV of the Argentina-U.S. BIT, and that those measures did not conform with the fair and equitable treatment owed to investors by virtue of Article II.2(a) of that treaty.<sup>19</sup> In response to these claims, Argentina maintained that the gas legal regime, including the license, established that companies had a right to a fair and reasonable tariff only and that Argentina had not given any guarantee concerning convertibility and currency devaluation.<sup>20</sup> In this regard, Argentina held that it had not made any commitment as to the maintenance of a specific exchange rate policy.<sup>21</sup> Finally, as a defense, Argentina posited that if there was any

13 *See id.* ¶ 62.

14 *See id.* ¶ 65.

15 *See id.* ¶ 66.

16 *See id.* ¶ 70, 1.

17 *See id.* ¶ 69.

18 *See id.* ¶ 89.

19 *See id.* ¶ 88.

20 *See id.* ¶¶ 91, 129.

21 *See id.* ¶ 94.

international liability, the national emergency served to justify an exemption from international responsibility.<sup>22</sup>

### ***B. The Findings and Conclusions of the CMS Award***

In order to dispose of the main claims of the case, the *CMS* tribunal evaluated whether Argentina had offered the following guarantees to CMS: (i) a right to tariffs calculated in U.S. dollars, and (ii) a right to tariff adjustments on the basis of the U.S. PPI.

Concerning whether CMS had a right to a tariff calculated in U.S. dollars, the tribunal's conclusion was that it did,<sup>23</sup> based on the legal regime, the context of the privatization process in Argentina and statements made by Argentine officials and bodies. Relevant for this conclusion was the statement of the Privatization Committee on October 2, 1992, according to which, "Section 9.2 leaves it sufficiently clear that the tariffs are in dollars and expressed in convertible pesos, for which reason, when faced with an eventual modification of the Convertibility Law, they

should be automatically re-expressed at the modified rate."<sup>24</sup> A compelling fact that helped the tribunal reach this conclusion was the extraordinary success of Argentina's privatization program, which had brought hundreds of companies to the country and foreign investment of U.S. \$10 billion.<sup>25</sup> According to the tribunal, these results would have not been achieved had Argentina not offered stability concerning tariffs.<sup>26</sup> For the same reasons, the tribunal reached the conclusion that CMS also had a right to a tariff adjustment in conformity with the U.S. PPI.<sup>27</sup> The general conclusion as to this matter was the following:

[T]he Tribunal is of the view that the meaning of the legal framework and the License, particularly in the context of the privatization, was to guarantee the stability of the tariff structure and the role the calculation in dollars and the U.S. PPI adjustment played therein. Devaluation could of course happen at some point, but then the tariff structure would remain intact within the framework of stability envisaged as it would remain intact within the framework of stability

22 *See id.* ¶ 99.

23 *See id.* ¶ 138.

24 *Id.* ¶ 135.

25 *See id.* ¶ 134-7.

26 *See id.* ¶ 137.

27 *See id.* ¶ 144.

envisaged as it would adjust automatically to the new level of exchange rate.<sup>28</sup>

Then the tribunal went on to evaluate the impact that the Argentine measures had had over the tariff structure and concluded that the devaluation and the tariff freeze had had mixed effects on TGN. On one hand, the measures reduced the operating costs of TGN and increased its exports income; on the other, the measures considerably increased the financial costs of the company, broadened TGN's gas export revenue<sup>29</sup> and significantly reduced the tariff revenue. On the whole, one of the main effects of the measures was that the tariffs were not fair and reasonable.<sup>30</sup>

The tribunal concluded that Argentina had failed to comply with its obligations pursuant to the licence conferred on TGN,<sup>31</sup> and it proceeded to assess CMS's claims of violation of the BIT.

The tribunal rejected the claim that Argentina's measures constituted an indirect expropriation of CMS's shares<sup>32</sup> in TGN contrary to Article IV(1) of the Argentina-U.S. BIT,<sup>33</sup> because "the investor is in control of the investment; the Government does not manage the day-to-day operations of the company; and the investor has full ownership and control of the investment."<sup>34</sup>

Turning to the claim of violation of fair and equitable treatment pursuant to Article II(2)(a) of the Argentina-U.S. BIT,<sup>35</sup> the *CMS* tribunal stated that the Argentine measures did not afford CMS such standard of treatment. The tribunal relied on the Preamble of the BIT, where one of the main objectives of the treaty was contemplated as to "maintain a stable framework for investment and maximum effective use of economic resources," and pointed out that "there can be no doubt, therefore, that a stable legal and business environment is an essential element of fair and equitable treatment."<sup>36</sup>

28 *Id.* ¶ 161.

29 *See id.* ¶ 195.

30 *See id.* ¶ 182.

31 *See id.* ¶ 252.

32 *See id.* ¶ 264.

33 Article IV(1) provides:

Investments shall not be expropriated or nationalized either directly or indirectly through measures tantamount to expropriation or nationalization ("expropriation") except for a public purpose; in a non-discriminatory manner; upon payment of prompt, adequate and effective compensation; and in accordance with due process of law and the general principles of treatment provided for in Article II (2).

34 CMS award, *supra* note 2, ¶ 263.

35 Article II(2)(a) sets forth:

Investment shall at all times be accorded fair and equitable treatment, shall enjoy full protection and security and shall in no case be accorded treatment less than that required by international law.

36 CMS award, *supra* note 2, ¶ 274.

Given that Argentina's measures had considerably altered the legal regime on the basis of which CMS had made its investment,<sup>37</sup> the tribunal concluded that such measures were in breach of the fair and equitable treatment embodied in Article II(2)(a) of the Argentina-U.S. BIT.<sup>38</sup>

Once the *CMS* tribunal considered that Argentina had breached the BIT, the tribunal dealt with the defense that the measures were justified either by international customary law or by the text of the treaty, since they were adopted in order to resolve a major economic crisis. The answers that the *CMS* award provided to this defense go straight to the main subject of this article.

### *C. Ex Post General Regulations Adopted to Face Economic Crises and Foreign Investors' Rights in the CMS Award*

The *CMS* award achieved a delicate balance between protecting investors' rights and recognizing that host States' ex post regulations adopted to solve an economic crisis could have some adverse impact on investors. In other words, the burden of an economic crisis was shared by both parties. The

following passages indicate this general orientation of the award:

The question for the Tribunal is then how does one weigh the significance of a legal guarantee in the context of a collapsing economic situation. It is certainly not an option to ignore the guarantee, as the Respondent has advocated and done, but neither is it an option to disregard the economic reality which underpinned the operation of the industry.

There is of course the question of the reality of the crisis that has been described. The Tribunal explained above that this reality cannot be ignored and it will not do so. The crisis, however, can only be taken into account as a matter of fact. And facts of course do not eliminate compliance with the law but do have a perceptible influence on the manner in which the law can be applied.<sup>39</sup>

The expression of this perspective was twofold in the award: first, neither international customary law nor the national security exception provided for in the BIT allowed Argentina to disregard previous commitments made to CMS. Second, Argentina's economic crisis was not ignored when the tri-

<sup>37</sup> See *id.* ¶ 275.

<sup>38</sup> *Id.* ¶ 281.

<sup>39</sup> *Id.* ¶¶ 165, 240.

bunal estimated the amount of compensation due to CMS.

### ***1. Ex Post Regulations and the State of Necessity under Customary International Law in the CMS Award***

Argentina sought to justify the adoption of the measures on the basis of the state of necessity engendered by the economic crisis by arguing that they were the only means available to face this crisis, which was not provoked by Argentina.<sup>40</sup>

The tribunal started its analysis with Article 25 of the Articles on State Responsibility, which reads:

1. Necessity may not be invoked by a State as a ground for precluding the wrongfulness of an act not in conformity with an international obligation of that State unless the act:
  - a is the only way for the State to safeguard an essential interest against a grave and imminent peril; and
  - b does not seriously impair an essential interest of the State or States towards which the obligation exists, or of the

international community as a whole;

2. In any case, necessity may not be invoked by a State as a ground for precluding wrongfulness if:
  - a the international obligation in question excludes the possibility of invoking necessity; or
  - b the State has contributed to the situation of necessity.

The *CMS* tribunal held that the conditions for the application of Article 25 had to be cumulatively fulfilled<sup>41</sup> and that the state of necessity had to be an exceptional tool.<sup>42</sup> In this sense, the tribunal found that there was a grave crisis in Argentina.<sup>43</sup> However, two requirements were not met. First, the tribunal considered that the measures were not the only ones available to solve the crisis.<sup>44</sup> Second, it considered that Argentina had contributed to the crisis, and it wrote in the award:

The second limit is the requirement for the State not to have contributed to the situation of necessity. The Commentary clarifies that this contribution must be “sufficiently substantial and not

40 *See id.* ¶ 312.

41 *See id.* ¶ 330.

42 *See id.* ¶ 317.

43 *See id.* ¶ 320.

44 *See id.* ¶ 324. Although the Tribunal did not explain this finding in detail, it is important to mention that the Tribunal had previously declared that the use of the adjustment mechanism provided for in the licence would have made it unnecessary for Argentina to adopt the measures of freezing TGN's tariffs. *See id.* ¶ 238.

merely incidental or peripheral.”...[t]he Tribunal is ... persuaded that similar to what is the case in most crises of this kind the roots ... include a number of domestic as well as international dimensions. This is the unavoidable consequence of the operation of a global economy where domestic and international factors interact.

The issue ... is whether the contribution to the crisis by Argentina has or has not been sufficiently substantial. The Tribunal ... must conclude that this was the case. The crisis was not the making of one particular administration and found its roots in the earlier crisis of the 1980s and evolving governmental policies of the 1990s that reached the zenith in 2002 and thereafter. Therefore, the Tribunal observes that government policies and their shortcoming significantly contributed to the crisis and the emergency and while exogenous factors did fuel additional difficulties they do not exempt the Respondent from its responsibility in the matter.<sup>45</sup>

This conclusion has significant consequences for host States. In effect, given their unavoidable

involvement, through wrong actions or omissions, in the creation of economic crises, the *CMS* tribunal’s conclusion means in real terms that such crises would hardly justify the invocation of the state of necessity by host States. Any justification for wrongful behaviour must then be expressly contemplated by the given BITs.

Absent two requirements of Article 25, the tribunal concluded that Argentina’s crisis could not preclude the illicitness of the measures Argentina adopted to resolve it.<sup>46</sup>

## *2. Justification of the Measures by Use of the Emergency Clause of the Argentina-U.S. BIT*

Argentina tried also to justify its measures by use of the emergency clause contained in Article XI of the BIT<sup>47</sup> and argued that Article IV(3) precluded any compensation to be paid to investors for measures adopted to face an economic crisis.<sup>48</sup> These provisions were set forth as follow:

This Treaty shall not preclude the application by either Party of measures necessary for the maintenance of public order, the

45 *Id.* ¶ 328 - 9.

46 *See id.* ¶ 331.

47 *See id.* ¶ 344.

48 *See id.* ¶ 389.

fulfillment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests.

Nationals or companies of either Party whose investments suffer losses in the territory of the other Party owing to war or other armed conflict, revolution, state of national emergency, insurrection, civil disturbance or other similar events shall be accorded treatment by such other Party no less favorable than that accorded to its own nationals or companies or to nationals or companies of any other third country, whichever is the most favorable treatment, as regards any measures it adopts in relation to such losses.

In order to decide whether Article IV(3) was applicable to the dispute, the tribunal examined, first, if economic crises were covered by Article XI, given that this type of crisis was not specifically contemplated in this provision. The tribunal broadly interpreted and concluded that Article XI covered grave economic crises, because neither the object nor purpose of the BIT nor international customary law excluded such type

of emergencies from Article XI.<sup>49</sup> The tribunal also indicated that, when dealing with measures enacted to face economic crises, the examination of their conformity with Article XI is comprised of the existence of the invoked crisis and its magnitude<sup>50</sup> in addition to whether the adopting States enacted the measures in good faith.<sup>51</sup>

After responding affirmatively to the inclusion of economic crises within Article XI, the tribunal responded negatively to the question whether Article IV(3) allowed Argentina to refuse to pay compensation for the losses that its emergency measures had caused investors to incur. In other words, the state of emergency did not preclude Argentina from indemnifying CMS for the losses it suffered as a result of the measures Argentina put in place to sort out its economic crisis.

The *CMS* tribunal based this important conclusion mostly on Article 27 of the Articles on State Responsibility, which expressly sets forth:

Consequences of Invoking a Circumstance Precluding Wrongfulness.

49 See *id.* ¶ 359.

50 See *id.* ¶ 373.

51 See *id.* ¶ 374.

The invocation of a circumstance precluding wrongfulness in accordance with this Chapter is without prejudice to:

a Compliance with the obligation in question, if and to the extent that the circumstance precluding wrongfulness no longer exists;

b The question of compensation for any material loss caused by the act in question.<sup>52</sup>

The tribunal held:

[A]rticle 27 establishes the appropriate rule of international law on this issue. The Respondent's argument is tantamount to the assertion that a Party to this kind of treaty, or its subjects, are supposed to bear entirely the cost of the plea of the essential interests of the other Party. This is, however, not the meaning of international law or the principles governing most domestic legal systems....

[T]he Respondent's expert clarifies the issue from the point of view of both its temporary nature (of the state of necessity) and the duty to provide compensation: while it is difficult to reach a determination as long as the crisis is unfolding, it is

possible to envisage a situation in which the investor have a claim against the government for the compliance with its obligations once the crisis was over; thereby concluding that any suspension of the right to compensation is strictly temporary, and that this right is not extinguished by the crisis events.<sup>53</sup>

### ***3. Temporary Character of an Ex Post Regulation Adopted to Face an Economic Crisis***

The *CMS* tribunal made another important implicit finding favoring foreign investors when it held that emergency measures enacted to face an economic crisis must be temporary and be in place only during the length of the crisis. Once the crisis is over, emergency measures should be lifted and host States' international obligations return. This inference can be made on the basis of the quotation that the *CMS* award contained of the International Court of Justice decision in *Rainbow Warrior*, in which it held that "as the state of necessity ceases to exist, the duty to comply with treaty obligations revives."<sup>54</sup>

### ***4. The CMS Award and the Impact of Argentina's Economic Crisis on CMS***

52 Responsibility of States for Internationally Wrongful Acts, available at [http://icil.law.cam.ac.uk/ILCSR/articles\(e\).doc](http://icil.law.cam.ac.uk/ILCSR/articles(e).doc).

53 *Id.* ¶¶ 390, 392.

54 *Id.* ¶ 380, citing *Rainbow Warrior*, RIAA, Vol. XX, 1990, 217, at 251-252, para. 75.

As was mentioned above, the *CMS* tribunal pointed out that, even though *CMS*'s rights had to be upheld by way of compensation during the crisis, the company could not ignore the economic and social realities provoked by the crisis. The tribunal held:

[T]he fact is that the Claimant cannot ask to be entirely beyond the reach of the abnormal conditions prompted by the crisis, as this would be unrealistic. However, at the same time, it would be wholly unjustifiable that the Claimant be overburdened with all the costs of the crisis . . .<sup>55</sup>

These realities were taken into account by the tribunal at the time it estimated the level of compensation Argentina had to pay to the investor:

The factual situation . . . allows the Tribunal to take into account different situations present at distinct periods in time. The crisis had in itself a severe impact on the Claimant's business, but this impact must to some extent be attributed to the business risk the Claimant took when investing in Argentina, this being particularly the case

as it is related to decrease in demand. Such effects cannot be ignored as if business had continued as usual. Otherwise, both parties would not be sharing some of the costs of the crisis in a reasonable manner and the decision could eventually amount to an insurance policy against business risk, an outcome that . . . would not be justified. On the other hand, a number of the measures adopted did indeed contribute to such hardship and the burden of those ought not to be placed on the Claimant alone . . .<sup>56</sup>

In order to reflect this finding in the estimation of the compensation due to *CMS*, the tribunal determined the duration of the crisis, business effects of which the company could not avoid. The tribunal considered that the crisis started on August 17, 2000, when a judge suspended the agreements postponing the tariff adjustments,<sup>57</sup> and it ended some time between the end of 2004 and the beginning of 2005.<sup>58</sup> The reduction of gas demand during these years was taken into account by the tribunal when it estimated *TGN*'s gas revenues during the time of the license.<sup>59</sup> This was the concrete impact that the crisis had on *CMS*.

55 *Id.* ¶ 244.

56 *Id.* ¶ 248.

57 *See id.* ¶¶ 62, 441.

58 *See id.* ¶ 250.

59 *See id.* ¶¶ 444 – 7.

### 5. *The CMS Award and the NAFTA Chapter 11 Award in Waste Management v. the United Mexican States with Regard to Economic Crises and Investment Protection*

The findings of the *CMS* award regarding the protection due to foreign investors even during economic crises and the temporary character of the measures adopted by host States to sort them out are of great significance for investors. In effect, such findings place most of the risk of economic crises on host States,<sup>60</sup> even though the investors, as was seen, must also bear certain consequences generated by these crises. In this sense, the *CMS* tribunal adopted an approach that considerably differed from that taken by the prior arbitral tribunal in the NAFTA Chapter 11 dispute in *Waste Management v. the United Mexican States*.<sup>61</sup> There the tribunal also analyzed the impact that an economic crisis may have on foreign investors' existing rights, but in that case the tribunal's conclusion and legal reasoning favoured host States to a great extent.

The *Waste Management* award resolved a dispute between an American investor against Mexico for the latter's failure to fulfil a contract for the provision of waste disposal services in the city of Acapulco,<sup>62</sup> signed in June 1995. Among the main causes of the failure was the Mexican economic crisis of the mid 1990s. *Waste Management* claimed that the several breaches of the contract by Mexico that led to the complete failure of the agreement infringed on the fair and equitable treatment principle provided for in NAFTA Article 1105(1).<sup>63</sup> The *Waste Management* tribunal rejected this claim by holding that Mexico's behaviour did not violate the principle because one of the causes for the breaches of the contract was the economic crisis suffered by the country in 1994. In other words, Mexico's, and in particular Acapulco's, behaviour was judged in light of the severe economic crisis it was facing and in light of the unsuccessful efforts it made in order to perform its obligations with *Waste Management* pursuant to the contract. The tribunal started by recognizing the existence of the Mexican crisis:

60 From an economic point of view, this result makes sense, because Host States are better placed than investors to control and mitigate the risk of economic crises.

61 *Waste Management Inc. v. United Mexican States*, Final Award, ICSID Case No. ARB(AF)/00/3. April 30, 2004 [hereinafter *Waste Management award*] (Members: James Crawford, Benjamin R. Civiletti, and Eduardo Magallon Gomez). available at [http://www.naftaclaims.com/disputes\\_mexico\\_waste.htm](http://www.naftaclaims.com/disputes_mexico_waste.htm).

62 See *id.* ¶ 40.

63 See *id.* ¶ 74.

*(ii) The allegations of breach of Article 1105(1)*

Before turning to the specific facts, the Tribunal notes that an important part of the background to the case was the Mexican financial crisis, which started in December 1994 with a substantial devaluation of the currency and continued for several years. During that period the value of the peso was approximately halved, the rate of inflation reached 38%, and federal revenues to the States and municipalities were greatly affected. The effects on the City were numerous: tourist numbers declined, its financial obligations under the Concession Agreement (which were indexed to inflation) were substantially increased and the federal revenues it received were substantially reduced.<sup>64</sup>

Then, the tribunal proceeded to evaluate Acapulco's behavior and declared:

[T]he question is whether, having regard to the conduct of the parties concerned and the general circumstances, losses were caused to Waste Management by the City in circumstances amounting to a breach of the minimum standard of treatment embodied in Article 1105,...

In the Tribunal's view the evidence before it does not support the conclusion that the City acted in a wholly arbitrary way or in a way that was grossly unfair. It performed part of its contractual obligations, but it was in a situation of genuine difficulty, for the reasons explained above. It sought alternative solutions to the problems both parties faced, without finding them. The most important default was its failure to pay; ... For present purposes it is sufficient to say that even the persistent non-payment of debts by a municipality is not to be equated with a violation of Article 1105, provided that it does not amount to an outright and unjustified repudiation of the transaction and provided that some remedy is open to the creditor to address the problem. In the present case the failure to pay can be explained, albeit not excused, by the financial crisis which meant that at key points the City could hardly pay its own payroll. There is no evidence that it was motivated by sectoral or local prejudice.

For these reasons the Tribunal is not satisfied that the City's breaches of contract rose to the level of breaches of Article 1105(1) of NAFTA.<sup>65</sup>

<sup>64</sup> *Id.* ¶ 101 (footnotes omitted).

<sup>65</sup> *Id.* ¶¶ 114 115, 117 (footnotes omitted).

As can be seen, the *Waste Management* tribunal's approach focused almost exclusively on the host State's conduct and critical circumstances and paid little attention to the affected investor's perspective. Basically, economic crises—irrespective of the State's contribution to them—accompanied by its attempts to comply with its obligations to foreign investors prevent it from infringing on the fair and equitable treatment principle.

By adopting a more holistic view of the problem and of the interests of both foreign investors and host States, the *CMS* award constitutes an important precedent from the foreign investors' perspective in the sense that their interests are better protected than under the legal reasoning and conclusions of the *Waste Management* award, without impairing host States' powers to enact measures aimed at solving, preventing or attenuating their economic crises.

#### ***D. General Inferences from the CMS Award Regarding an Ex Post Regulation Adopted for Economic Emergency Reasons***

Interpreting BITs in a more balanced way between investors'

and host States' interests was paramount for the *CMS* tribunal and produced important consequences that could be taken into account by other international arbitral tribunals adjudicating investor/State disputes involving measures adopted to solve economic crises.

From the foreign investors' perspective, the *CMS* award contains the following key positive findings: First of all, foreign investors' rights set forth in legal or contractual regimes are protected if an ex post regulation enacted in response to a grave economic crisis changes the investors' rights. Second, a violation of the fair and equitable principle is declared if an ex post regulation considerably alters investors' rights. Third, investors must also be compensated for the losses suffered by an ex post regulation enacted by host States to solve an economic crisis.<sup>66</sup> This is a significant improvement when compared with the *Waste Management* award. Fourth, the host States' possibility of invoking the state of necessity provided in international customary law for reasons linked to an economic crisis was severely limited by the *CMS* award. Indeed, the host States'

<sup>66</sup> Save explicit treaty text holding otherwise.

contribution to the occurrence of these crises is virtually unavoidable; thus at least one requirement of Article 25 to legally invoke the state of necessity is not fulfilled, thereby benefiting foreign investors. Fifth, an ex post regulation adopted to solve an economic crisis and adversely affecting investors' rights must be temporary and last only until the crisis is controlled.

Although, from the host States' perspective, the foregoing conclusions somehow affect them negatively, the *CMS* award could be seen as endorsing the following general propositions that favor such States:

First, economic crises can be protected under emergency clauses of BITs, even if they are not explicitly mentioned in the text of the clause. Second, host States can adopt an ex post regulation altering investors' rights as part of the measures to overcome crises of this nature. Third, the estimation of compensation due to foreign investors for losses caused by the application of an ex post regulation altering their rights must take into account the realities of the economic crises.

## II. EX POST GENERAL REGULATION AFFECTING FOREIGN INVESTORS WITH WHOM THE HOST STATE LACKS A LEGAL RELATIONSHIP

Foreign investors that lack a specific legal relationship with a host State may find, however, that their business is affected by the enactment of new regulations not in place at the time the investment was made. The question as to who bears the burden of the new regulation, whether the host State or the foreign investor, is then relevant for both parties, in particular when the burden is considerable. The general rule is that investors bear the burden of general ex post regulations. For instance, the NAFTA award in *Feldman v. United Mexican States*, quoting the *Restatement Third, Foreign Relations Law of the United States*, held:

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 power of states, if it is not discriminatory.<sup>67</sup>

<sup>67</sup> Final Award *Feldman v. United Mexican States*, (2002) 7 ICSID REP. 318, 367-70.

The *Methanex* final award<sup>68</sup> dealt precisely with a situation in which, as a result of an ex post general environmental regulation, a foreign investor suffered great losses. Indeed, Methanex, a Canadian investor, was claiming about one billion U.S. dollars from the United States as a result of environmental measures adopted by the state of California.<sup>69</sup> The *Methanex* tribunal made important findings supporting host States' powers to enact ex post environmental regulations. In effect, absent the States' previous commitments not to enact new regulations, their prerogative to regulate remains broad.

### A. Brief Description of the Facts of the *Methanex* Dispute

Methanex is the world's largest producer of methanol, with a strong presence in the United States and in particular in California,<sup>70</sup> where this chemical product was used as a feedstock of MTBE, a product utilized as an oxygenate in gasoline.<sup>71</sup> Because of the

environmental risks to California ground waters—the state's main source of water supply—from leakage of gasoline containing MTBE, California imposed a ban on the use of MTBE as an oxygenate of gasoline, effective December 31, 2002.<sup>72</sup> Although Methanex did not produce MTBE,<sup>73</sup> it alleged that the ban was not aimed at protecting the environment, but at favoring the American ethanol industry, whereby ethanol, being another oxygenate for gasoline, took the market share that had been in the hands of MTBE producers.<sup>74</sup> As proof of such intent, Methanex claimed that the ban was adopted due to the lobbying by and financial support of the largest American ethanol producer<sup>75</sup> for the campaign of the then-Lieutenant Governor Davis, who, once in office, enacted the ban on the use of MTBE.

Methanex claimed that the California ban on the use of MTBE violated the principle of national treatment set forth in NAFTA Article 1102, that the treatment

68 Final Award of the Tribunal on Jurisdiction and Merits, In the Matter of An International Arbitration Under Chapter 11 of the North American Free Trade Agreement and the UNCITRAL Arbitration Rules Between Methanex Corporation and the United States of America. Aug. 3, 2005 [hereinafter *Methanex* award] (Members: J. William F. Rowley, W. Michael Reissman, and V.V. Veeder). available at [http://naftaclaims.com/Disputes/USA/Methanex/Methanex\\_Final\\_Award.pdf](http://naftaclaims.com/Disputes/USA/Methanex/Methanex_Final_Award.pdf).

69 See *id.* Part I, Preface ¶ 1.

70 See *id.* Part II, Ch. D ¶ 3.

71 See *id.* Part II, Ch. D ¶ 2.

72 See *id.* Part I, Preface ¶ 2.

73 See *id.* Part I, Preface ¶ 1.

74 See *id.* Part II, Ch. D ¶ 24.

75 See *id.* Part II, Ch. A No 11.

accorded to Methanex was not fair and equitable as ordered by NAFTA Article 1105, and that the ban was a measure tantamount to expropriation for which compensation was required by virtue of NAFTA Article 1110.

### ***B. Brief Description of the Process Leading to the California Ban on MTBE***

Measures aimed at banning MTBE arose in the 1990s, when concerns about the potential risks of using MTBE in gasoline increased.<sup>76</sup> As a result of these concerns, the California Senate, before Governor Davis took office, unanimously passed a bill ordering a complete scientific study to be carried out by the University of California (“UC”) regarding the risks that the use of MTBE as an oxygenate in gasoline posed for the environment and California ground waters.<sup>77</sup> The study had a peer review and concluded that, in effect, MTBE posed a risk for Californian ground waters due to potential leaks from underground storage tanks of

gasoline containing it,<sup>78</sup> although the actual risk to consumers was low.<sup>79</sup> The study also concluded that the costs of treatment of MTBE-contaminated water were enormous<sup>80</sup> and suggested a ban on the use of MTBE as an oxygenate in gasoline to be put in effect after a transitional period.<sup>81</sup> Once the study was released, there was a phase for public comments, and the findings and conclusions of the study received the support of other state and federal agencies.<sup>82</sup>

### ***C. The Findings and Conclusions of the Methanex Tribunal***

The *Methanex* tribunal rejected all of Methanex’s claims<sup>83</sup> and decided that the California measure was adopted in accordance with Due Process, was for a public purpose, was not discriminatory,<sup>84</sup> and had adequate scientific support.<sup>85</sup> Additionally, the tribunal held that there was no proof of California’s intent to harm Methanex or to favor the United States’ ethanol industry,<sup>86</sup> so given that Methanex did not produce MTBE, the

76 *See id.* Part III, Ch. A ¶ 20.

77 *See id.* Part III, Ch. B ¶ 11.

78 *See id.* Part III, Ch. B ¶ 10.

79 *See id.* Part III, Ch. B ¶ 11.

80 *See id.* Part III, Ch. B ¶ 12.

81 *See id.* Part III, Ch. B ¶ 15.

82 *See id.* Part III, Ch. B ¶ 19.

83 *See id.* Part VI, No 2.

84 *See id.* Part IV, Ch. D ¶ 15.

85 *See id.* Part III, Ch. A ¶ 101, 102.

86 *See id.* Part III, Ch. A ¶ 102(3) and (4), and Part IV, Ch. E ¶ 20.

measure containing the ban was not related to its investment, and therefore the tribunal lacked jurisdiction.<sup>87</sup>

In particular, when dismissing the claim of wrongful expropriation, the *Methanex* award put some brakes on any possible expansion of the economic interest that can be subject to expropriation. Encouraged by the *Pope & Talbot* award, in which it was said that “market shares” qualified as an investment,<sup>88</sup> Methanex went a step further and argued that the California ban had expropriated its market share of the methanol market in California, affected its goodwill, and deprived it of its customer base.<sup>89</sup> The tribunal held that, without denying the fact that property is no longer associated with tangible goods and that “managerial control over components of a process that is wealth producing” can also be regarded as property,<sup>90</sup> concepts such as market share, goodwill, and customer base were important for the valuation process of the assets involved in an expropriation, but that it was not clear how they could qualify as investments on their own.<sup>91</sup>

At least for now, it is unclear if these interests are “investments” that can be the object of expropriation or measures tantamount to expropriation. A finding that they were would mean that investors would have to demonstrate the existence of expropriation on a large scale, and once that had been accomplished, they would have to prove the lost value of the goodwill, market share, and customer base of the expropriated assets in order to get compensation for the damages affecting these interests. The investors’ burden of proof would be considerably higher under that scenario than if they had to show only that, as a result of the given regulation, such interests had lost their value and were thus subject to a measure tantamount to expropriation, and therefore, full compensation was owed by the host State.

#### ***D. Ex Post General Regulation, Foreign Investors, and The Methanex Award***

For environmental regulatory authorities, the *Methanex* award contains or reaffirms their

87 See *id.* Part IV, Ch. E ¶ 22.

88 See *id.* Part IV, Ch. D ¶ 17.

89 See *id.* Part IV, Ch. D ¶ 5.

90 See *id.* Part IV, Ch. D ¶ 17.

91 See *id.* Part IV, Ch. D ¶ 17.

regulatory power in a number of ways, although with an important exception. Although the findings are closely tied to the complex facts of the case, there are lessons to be learned by agencies that wish to adopt ex post regulations that can successfully resist challenges by private foreign investors.<sup>92</sup>

### *1. Host-States' Broad Powers to Make Distinctions between Domestic and Foreign Investors*

When resolving the claim of violation of the national treatment principle, the *Methanex* award widened the scope of NAFTA States' powers to draw regulatory distinctions between national and foreign investors, and accordingly reduced the latter's level of protection. In effect, Methanex claimed that the U.S. had not accorded to it the treatment granted to American ethanol investors, which

were in like circumstances, because both methanol and ethanol were oxygenates for gasoline.<sup>93</sup>

When analyzing this claim, the tribunal took the view that the comparator was that considered to be in the most "like circumstance" rather than in the less "like circumstance." It stated:

[G]iven the object of Article 1102 and the flexibility the provision provides in its adoption of "like circumstances," it would be as perverse to ignore identical comparators if they were available and to use comparators that were less "like," as it would be perverse to refuse to find and to apply less "like" comparators when no identical comparators existed. The difficulty which Methanex encounters is that there are comparators which are *identical* to it.<sup>94</sup>

92 In addition to dealing with the scope of ex post environmental regulations, the *Methanex* tribunal established valuable elements related to how the enactment process can ensure that the new regulations will not engender States' international responsibility. First, transparency in the process of adoption of environmental measures is a shield against investors' claims. In effect, the transparent way in which the Californian ban on gasoline containing MTBE was adopted was a key factor of the decision and proved to be an invincible obstacle for Methanex. In effect, the ban was enacted following a unanimous political decision of the California Senate prior to Governor Davis's election, and it was based on a solid scientific study. This transparent process showed that the threat to Californian ground waters posed by gasoline containing MTBE was certain and that there was a general concern in California for the adverse environmental impact of leakage of gasoline containing MTBE. The measure was then adopted for a public purpose and was not aimed at benefiting the ethanol industry, nor was it the result of the industry's lobbying of Governor Davis.

Second, an environmental regulation should be based on sufficient, although not unanimous, scientific support and be adopted in good faith. Indeed, another important fact that received considerable attention by the tribunal was that California's ban of MTBE was based on a scientific study, subject to strict peer review, that received the support of other American public agencies. Given the UC's conclusions, the *Methanex* tribunal regarded the MTBE ban as a good faith exercise of California's regulatory powers. *See* Part III, Ch. A ¶ 102(2). Finally, also important for regulatory agencies is the role of good faith for the *Methanex* tribunal regarding the enactment of the ban. The tribunal stated that the California ban on the oxygenate MTBE "was motivated by the honest belief, held in good faith and on reasonable scientific grounds, that MTBE contaminated groundwater and was difficult and expensive to clean up." *See* Part III, Ch. A ¶ 102(2).

93 *See id.* Part IV, Ch. B ¶ 26.

94 *Id.* Part IV, Ch. B ¶ 17.

Given that there was a methanol industry in the United States, the tribunal therefore held that the proper comparator was the treatment received by this industry. The U.S. methanol industry was equally affected by the California ban, so Methanex did not receive a treatment different from the one afforded to national investors.<sup>95</sup>

The inference that can be drawn from this finding is that, for NAFTA regulatory agencies, the national treatment obligation stops in the face of an identical domestic industry or investors, and it does not extend to better treatment accorded by ex post regulations to other industries that could be considered to be in like circumstances with the foreign investor. In other words, if regulatory agencies treat a domestic investor in like circumstances better than another domestic investor, the foreign investor identical to the latter is not entitled to receive the treatment accorded to the former. No doubt, this finding reduces the scope of the national treatment principle when there are identical

foreign and domestic investors and there is another domestic investor in like circumstances, albeit less “like,” receiving better treatment.<sup>96</sup>

## 2. Broad Scope of Ex Post Environmental Regulations in the Methanex Award

Regarding ex post regulations, the *Methanex* tribunal went even further than narrowing the scope of the national treatment, because it implicitly held that NAFTA States can adopt new environmental legislation, except those that they had committed themselves with investors not to enact. When dealing with Methanex’s claim that the MTBE ban was a measure tantamount to expropriation,<sup>97</sup> the tribunal, relying on the *Waste Management* award and on a non-NAFTA ruling, *Revere Copper & Brass Inc v. Overseas Private Investment Corporation*,<sup>98</sup> pointed out:

[A]s a matter of general international law a non-discriminatory regulation adopted for public purpose, which is enacted in accordance with due process and, which affects . . . a foreign investor or investment is not deemed expropriatory and compensable unless

95 See *id.* Part IV, Ch. B ¶¶ 19 & 21. The *Methanex* tribunal based this conclusion on the award in *Pope & Talbot v. Canada*. See *id.* Part IV, Ch. B ¶ 19, which faced a similar situation. However, the very important conceptualization of “more” and “less” “like circumstances” is the sole creation of the *Methanex* tribunal.

96 This restrictive evaluation of the term “like circumstances” in the national treatment principle is in striking contrast with the view of the tribunal in *Occidental Petroleum and Exploration Company v. the Republic of Ecuador*, in which the oil industry was regarded to be in similar circumstances with the cut flower, lumber, mining, banana, and palm oil industries for the purpose of national treatment pursuant to the Ecuador-U.S. BIT. See *infra* Part IV.B.

97 See *Methanex* award, *supra* note 68, Part IV, Ch. D ¶ 2.

98 *Revere Copper & Brass Inc v. Overseas Private Investment Corporation*. 56 I.L.R. 258 (1980).

specific commitments had been given by the regulating government to the then putative investor contemplating investment that the government would refrain from such regulation.”<sup>99</sup>

No doubt, by considering that host States are responsible only for the ex post regulations that they had committed themselves with investors not to enact, the *Methanex* tribunal gave NAFTA States great latitude to put into place new legislation that could affect foreign investors without the risk of having to compensate them for such harm. It is finally important to highlight that the *Methanex* tribunal did not specify where the commitment must be found. In *Waste Management* and in *Revere Copper & Brass Inc v. Overseas Private Investment Corporation*, there was a contract between the investor and the State, so their finding condemning an unexpected ex post regulation that was in breach of the agreement was a normal consequence. But the *Methanex*

tribunal relied on these two arbitration awards despite the substantial difference in the factual situation: Methanex did not have any contract with California. One could interpret such reliance as meaning that, per the *Methanex* tribunal, it is not necessary that the commitment be contained in a contract; therefore, even a unilateral promise in domestic legislation could apparently qualify as a representation of this type, which the investor could invoke for his or her benefit. In the instant case, the tribunal declared that Methanex entered the U.S. market without being assured by the U.S. government that the MTBE ban would not be enacted,<sup>100</sup> so Methanex was not entitled to any compensation as a result of the ban.<sup>101</sup>

In sum, the *Methanex* award leaves broad discretion to NAFTA host States to enact ex post general regulations that could negatively affect foreign investors with whom there is no a specific legal relationship.<sup>102</sup> The

99 Methanex award, *supra* note 68, Part IV. Chapter D. ¶ 7. To support this argument, the *Methanex* Tribunal quoted the *Waste Management* award and pointed out:

[I]n *Waste Management v. Mexico*, the tribunal stated with respect to the “minimum standard of fair and equitable treatment”, that in applying this standard it is relevant that the treatment is in breach of *representations made by the host state which were reasonably relied upon by the claimant*. *Id.* Part IV, Ch. D ¶ 8 (emphasis in original).

100 *See id.* Part IV, Ch. D ¶ 10.

101 *See id.* Part IV, Ch. D ¶ 15.

102 One should be cautious in assuming that the *Methanex* award stands for the proposition that, in the absence of previous commitments by Host States not to regulate, they could go so far as to adopt new legislation that could even expropriate investors’ investment without compensation. For unexpected ex post regulation of this sort the *Methanex* tribunal expressed nothing, and other arbitration tribunals have held that compensation is owed to the aggrieved investor. In effect, the tribunal in *Compañía del Desarrollo de Santa Elena, S.A. v. Republic of Costa Rica* stated:

Expropriatory environmental measures – no matter how laudable and beneficial to society as a whole – are, in this respect, similar to any other expropriatory measures that a state may take in order to implement its policies: where property is expropriated, even for environmental purposes, whether domestic or international, the state’s obligation to pay compensation remains. (ICSID case No. ARB/96/1, 15 ICSID REV. FOREIGN INVESTMENT L. J., ¶ 72, 192 (2000)). The tribunal in *Técnicas Medioambientales Tecmed S.A. v. the United Mexican States* relied also on this finding. *See* International Centre for Solution of Investment Disputes, *Técnicas Medioambientales Tecmed S.A. v. the United Mexican States*, Award, ICSID Case No ARB(AF)/00/2, May 29, 2003, ¶ 121n. 139.

likelihood of responsibility for breaches of specific representations not to adopt such ex post regulations remains exceptional for the benefit of foreign investors.

### III. EX POST LACK OF APPLICATION OF EXTANT REGULATIONS, INVESTMENT PROTECTION, AND THE NAFTA AWARD IN *GAMI INVESTMENT INC. V. THE GOVERNMENT OF THE UNITED MEXICAN STATES*

For foreign investors, legal stability means not only that ex post regulations will not affect their investments, but also that the extant regulations on which investors relied will be enforced after the investment is made. Thus, legal security is not ensured when an extant regulation is not applied ex post, and such lack of application harms foreign investors. This said, it is important to assess this situation from the host States' perspective.

What legislation to enforce and to what degree is a decision governments must make on the basis of their priorities and on what

they consider to be the best use of their limited economic, administrative, and human resources. Thus, given that it is materially impossible to enforce all legislation at the same time, to some extent, governments make choices concerning what norms will be enforced and the different degree of enforcement that will be pursued. A conflict will arise if an investor relied on the enforcement of certain legislation at the time it made the investment, and later a host States determines tacitly or expressly that the enforcement of such legislation will not receive preference.

This situation was at the heart of the NAFTA Chapter 11 dispute in *Gami Investment Inc v. the Government of the United Mexican States*,<sup>103</sup> and the tribunal that resolved it handed down an award that, although opening the door for compensating foreign investors for lack of enforcement of a regulation, assigned host States broad discretion in deciding such enforcement, because the conditions to be met in order to find States internationally responsible for omissions of this sort are quite strict.

<sup>103</sup> In the Proceedings pursuant to NAFTA Chapter 11 and the UNCITRAL Arbitration Rules. *Gami Investment Inc v. the Government of the United Mexican States*, Final Award, November 14, 2004. [hereinafter *Gami award*]. (Members of the Tribunal: W. Michael Reissman, Julio Lacarte Muró, and Jan Paulsson). Available at <http://naftaclaims.com/Disputes/Mexico/GAMI/GAMIfinalAward.pdf>.

### A. *The Facts of the GAMI Dispute*

Grupo Azucarero Mexico SA de CV (“GAM”) acquired sugar mills from Mexico at the end of the 1980s and the beginning of the 1990s.<sup>104</sup> In 1991, Mexico enacted the Sugarcane Decree,<sup>105</sup> which stated that all phases of the sugarcane industry were to be regarded as being of public interest.<sup>106</sup> This industry had a significant political dimension in Mexico, due, first, to historic considerations derived from the four centuries of existence of the industry; second, to its contribution to Mexican labor (30,000 people worked as *cañeros*); and third, to the diversification of the industry, since 66 percent of the sugarcane was grown on small fields of no more than eight hectares.<sup>107</sup> Another important characteristic of the sugarcane industry was the interdependence between *cañeros* and mills. Given that sugarcane must be processed within 24 hours of harvesting, *cañeros* need mills, and mills depend on *cañeros* in the area. A witness in the arbitral proceeding called this situation a “bilateral monopoly.”<sup>108</sup>

In December 1996, GAMI, a company constituted under the laws of the United States, acquired shares in GAM, and by successive purchases got 14.18 percent of GAM’s common shares.<sup>109</sup>

The Sugarcane decree was to be implemented by the *Comité de la Agroindustria Azucarera* (“CAA”). The CAA was presided over by the Mexican Secretary of Agriculture, along with the Secretary of Economy; they were the only government representatives in the CAA. Mills and *cañeros* had two representatives each.<sup>110</sup> The second entity established by the decree was the *Comités de Producción Cañera de los Ingenios del País*, consisting of the leader of each respective organization of *cañeros* and mills, without the government having a representative.<sup>111</sup> The third entity was the *Junta de Conciliación de Arbitraje de Controversias Azucareras* (“JCACA”), charged with the duty to resolve disputes between *caneros* and mills. The Mexican government, mills, and *cañeros* constituted this Board.<sup>112</sup>

The Sugarcane Decree sets forth as objectives the following two:

104 *See id.* ¶ 12.

105 *See id.* ¶ 52.

106 *See id.*

107 *See id.* ¶ 46.

108 *Id.* ¶ 45.

109 *See id.* ¶ 13.

110 *See id.* ¶ 53.

111 *See id.* ¶ 54.

112 *See id.* ¶ 55.

[I]t is necessary to promote the [sugar] industry by giving economic certainty to the different sectors that participate in production thereof, such that said production be profitable, and also be able to foment its own growth.

That it is necessary for trade policies to allow for a permanent sugar supply, thus it is prudent to link the price of sugarcane to that of sugar so as to ensure equity to all participants in the production chain.<sup>113</sup>

The Sugarcane Decree was complemented by a first *Acuerdo* adopted on March 25, 1997, in which a methodology was agreed upon to set the national reference price for sugarcane<sup>114</sup> and to establish measures mills would have to comply with regarding export quotas, the lack of compliance with which would lead to the imposition of penalties.<sup>115</sup> A second *Acuerdo* was established in 1998 regarding limits to production by mills, with penalties if they were not met.<sup>116</sup> The underlying goal of the sugarcane regulation was to limit production either by reducing production of sugar or by promoting exports.

There was a disagreement regarding the nature of the Mexican sugarcane regulation. For GAMI, it contained obligations to be fulfilled by the Mexican government. For the latter, it was a regulation to be applied by consensus between *cañeros*, mills,<sup>117</sup> and the government, and the lack of application of the regulation was attributed to the *cañeros* and mills' passivity.<sup>118</sup>

GAMI contended that the regulation was not enforced by Mexico. First, GAMI argued that Mexico failed to put in place the conditions for the establishment of the national reference price for sugarcane; in particular, Mexico did not provide information regarding prices at the end of the harvest. The consequence for GAM of this omission was overpayment to *cañeros* over four years.<sup>119</sup> Second, Mexico failed to ensure that mills complied with their export quotas. Those that were not exporting were not penalized by JCACA.<sup>120</sup> Third, GAMI claimed that Mexico had not enforced production limits.<sup>121</sup>

According to the company, the general effects on this failure to

113 *Id.* ¶ 56.

114 *See id.* ¶ 59.

115 *See id.* ¶ 61.

116 *See id.* ¶ 63.

117 *See id.* ¶ 57, 62.

118 *See id.* ¶ 71.

119 *See id.* ¶ 68.

120 *See id.* ¶ 70.

121 *See id.* ¶ 81, 2.

enforce the sugarcane regulation were that sugar: was dumped on the domestic markets. Mills were caught between low prices for their product and the regulated high cost of their primary raw-material (sugarcane). The entire industry experienced a crisis beginning in 1999. The result for GAM was a filing for *suspension de pagos* (suspension of payments). This judicial procedure was intended to allow the restructuring of GAM's debt and its avoidance of bankruptcy.<sup>122</sup>

The failure transformed GAM's operating profits of M \$368 million in 1996 to an operating loss of M \$302 million in 2000.<sup>123</sup>

For these reasons, GAMI claimed that Mexico's lack of enforcement of the sugarcane regulation was contrary to the principle of fair and equitable treatment provided for in NAFTA Article 1105 and that it had led to a wrongful expropriation of GAMI's shares in GAM due to the total loss of their value, contrary to NAFTA Article 1110.<sup>124</sup>

## ***B. The Findings and Conclusions of the GAMI Award***

Even though the *GAMI* tribunal declared that "GAMI has comprehensively demonstrated that the regulations which it refers to as 'the Mexican Sugar Program' were not carried out in accordance with their terms ...,"<sup>125</sup> the *GAMI* tribunal rejected all claims. As to the violation of the principle of the fair and equitable principle, the tribunal basically held that, as will be seen below, failure to enforce a regulation may infringe upon international law. However, in the instant case, the *GAMI* tribunal considered that the sugarcane regulation "was structured on the premise of broad consultation and cooperation,"<sup>126</sup> and "it is not certain that the Mexican government was the sole and critical actor."<sup>127</sup>

On the other hand, according to the tribunal, the fair and equitable principle was not violated, because there was no proof of Mexico incurring "outright and unjustified repudiation' of the relevant

122 *Id.* ¶ 16.

123 *See id.* ¶ 66.

124 *See id.* ¶ 24. There was also a claim of discrimination on the basis of Article 1102 because Mexico did not expropriate mills of other companies that were in like circumstances as GAM. *See id.* This claim goes beyond the scope of this paper, and it will not be analyzed.

125 *Id.* ¶ 86. *See also* ¶ 103.

126 *Id.* ¶ 110.

127 *Id.* ¶ 104.

128 *Id.* ¶ 104.

regulations.”<sup>128</sup> This was so because Mexico showed that it had made significant efforts to solve the problem of the excess sugar on the Mexican market. Paramount among them were Mexico’s attempts to ensure access for its sugar to the U.S. market<sup>129</sup> in a long dispute with the United States regarding what both States agreed on in the North American Free Trade Agreement. The dispute ended with the imposition by Mexico of important taxes on beverages sweetened with fructose, a product mostly imported from the U.S., which led to a significant increase of consumption of Mexican sugar.<sup>130</sup> But these were not the only attempts. Mexico demonstrated that it had made others, such as granting subsidies to mills complying with export quotas<sup>131</sup> and launching anti-dumping investigations against fructose producers in the United States.<sup>132</sup> Moreover, during the arbitral proceedings, GAMI stated that the sugarcane regulation was being appropriately implemented and “the system was working now.”<sup>133</sup>

The tribunal concluded:

GAMI has not shown that the government’s self-assigned duty in the regulatory regime was simple and unequivocal. It is impossible to conclude that the failures in the Sugar Program were both directly attributable to the government and directly causative of GAMI’s alleged injury.<sup>134</sup>

As to the claim of wrongful expropriation of GAMI’s shares in GAM, the tribunal rejected it, because it was not proved how the expropriation of some of the mills had affected the value of GAM’s shareholding.<sup>135</sup> The tribunal did not analyze how the lack of implementation of the Sugar Program had affected GAMI’s investment in GAM, because GAMI did not provide proof of the loss of value of its shares as a result of such lack of enforcement.<sup>136</sup> The tribunal also rejected GAMI’s claims as to violation of the principle of non-discrimination. The tribunal found that the Expropriation Decree of mills had been issued as a valid policy<sup>137</sup> and that GAMI had failed

129 See *id.* ¶ 77(a).

130 See *id.* ¶ 84. The Mexican taxes have been declared recently inconsistent with Article III of the GATT/1994 by a WTO panel and, on appeal, by the WTO Appellate Body. See WTO Appellate Body Report, *Mexico – Tax Measures on Soft Drinks and Other Beverages*, WTO Doc. WT/DS308/AB/R, March 6, 2006. WTO Panel Report, *Mexico—Tax Measures on Soft Drinks and Other Beverages*, WTO Doc. WT/DS/308/R, October 7, 2005.

131 See *GAMI Award*, *supra* note 103, ¶ 77(c).

132 See *id.* ¶ 77(d).

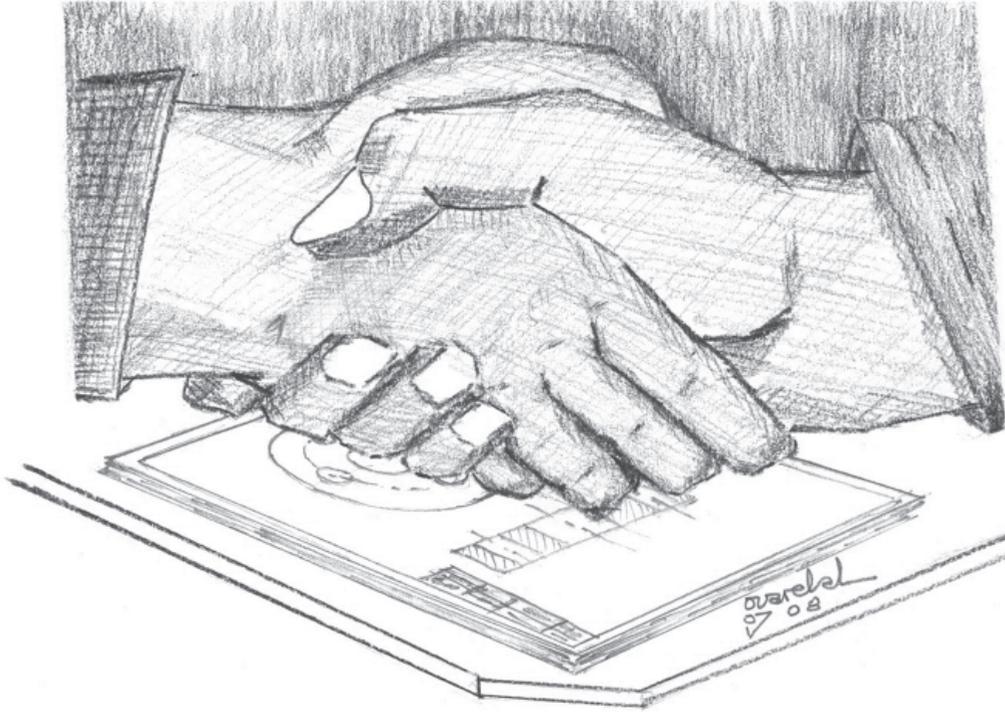
133 *Id.* ¶ 83, 4.

134 *Id.* ¶ 110.

135 See *id.* ¶ 132, 3.

136 See *id.* ¶ 84, 5.

137 See *id.* ¶ 114.



to prove that the expropriation had been taking place due to GAMI's investment in GAM.<sup>138</sup>

*C. The GAMI Tribunal and Host States' International Responsibility Resulting from Failure to Enforce Regulation Affecting Foreign Investors*

The GAMI tribunal made significant statements regarding the conditions under which host States are liable for the failure to enforce their regulations. For the tribunal, “[t]he key question is the extent to which an investor may rely on the implementation by the host state of laws in place before its investment is made. What efforts by a government to implement its regulatory programme suffice to fulfil the international standards

requirements of Article 1105?”<sup>139</sup>

The tribunal started by holding that lack of enforcement of a regulation may well violate the fair and equitable principle embodied in BITs. The GAMI tribunal stressed:

International law does not appraise the content of a regulatory programme extant before an investor decided to commit. The inquiry is whether the state abided by or implemented that programme. It is in this sense that a government's failure to implement or abide by its own law in a manner adversely affecting a foreign investor may but will not necessarily lead to a violation of Article 1105. Much depends on context ...<sup>140</sup>

138 *See id.* ¶ 115.

139 *Id.* ¶ 100.

140 *Id.* ¶ 91.

The tribunal went on to set forth two pre-conditions for host States' responsibility for lack of enforcement of their regulations. The first is that the government's self-assigned duty to enforce must be "simple and unequivocal."<sup>141</sup> The second is that the maladministration would have to amount to an "outright and unjustified repudiation" of the relevant regulations,<sup>142</sup> although the tribunal also pointed out that it is only after an evaluation of the whole record in the case that the violation of the principle can be determined.<sup>143</sup>

However, for the *GAMI* tribunal, lack of enforcement by host States does not, in and of itself, lead to violation of the fair and equitable principle provided for in BITs, because it is important to assess host States' efforts to implement their regulation before making a finding of breach of international law. The tribunal found, on the basis of the previous NAFTA awards in *Waste Management* and *ADF Group*:

Four implications of *Waste Management II* are salient even at the level of generality ... (1)The failure to fulfill the objectives of administrative regulations does not

necessarily rise to a breach of international law; (2)A failure to satisfy requirements of national law does not necessarily violate international law; (3)Proof of a good faith effort by the Government to achieve the objectives of its laws and regulations may counterbalance instances of disregard of legal or regulatory requirements; (4)The record as a whole – not isolated events – determines whether there has been a breach of international law. ...<sup>144</sup>

Despite the above-mentioned positive finding from the host States' perspective, the *GAMI* tribunal did not allow them to justify the lack of enforcement of their regulations on grounds such as costs or difficulty. The *GAMI* award reads: The duty of NAFTA tribunals is ... to appraise whether and how preexisting laws and regulations are applied to the foreign investor. It is no excuse that the regulation is costly. Nor does a dearth of able administrators or a deficient culture of compliance provide a defense. Such is the challenge of governance that confronts every country. Breaches of NAFTA are assuredly not to be excused on the grounds that a government's compliance with its own laws may be difficult.

141 *Id.* ¶ 110.

142 *Id.* ¶ 104.

143 *See id.* ¶ 110.

144 *Id.* ¶ 97.

Each NAFTA Party must to the contrary accept liability if its officials fail to implement or implement regulations in a discriminatory or arbitrary fashion.<sup>145</sup>

Finally, the *GAMI* tribunal sought to set the limits arbitration tribunals possess when evaluating investors' claims concerning lack of enforcement of regulations as a basis for breach of international law: tribunals cannot evaluate host States' laws but only how they have applied them to investors. The *GAMI* tribunal maintained:

[N]AFTA arbitrators have no mandate to evaluate laws and regulations that predate the decision of a foreigner to invest. The present tribunal endorses and adopts the following passages from *S.D. Myers*:

*“When interpreting an applying the ‘minimum standard’, a Chapter 11 tribunal does not have an open-ended mandate to second-guess government decision making. Governments have to make many potentially controversial choices. In doing so, they may appear to have made mistakes, to have misjudged the facts, proceeded on the basis of a misguided economic or sociological theory, placed too much emphasis on some social values over others and adopted solutions that are ultimately ineffective or*

*counterproductive. The ordinary remedy, if there were one, for errors in modern government is through internal political and legal process, including elections.”*<sup>146</sup>

In sum, the *GAMI* tribunal set a high bar for a successful claim of breach of the fair and equitable principle due to host States' *ex post* failure to enforce regulations existing at the time foreign investors made their investment. First of all, the enactment of the legislation does not in itself lead to the State's duty to enforce it; it is necessary for the State to assign itself this duty; and it cannot be ambiguous, but must be “unequivocal.” Second, even if the duty to enforce exists, the failure to comply with the duty must come from an “unjustified repudiation,” so the given host State must adopt an express decision in which it states that it will not comply with its duty to enforce, and the decision must lack justification, according to the *GAMI* tribunal, so there could be occasions in which the repudiation existed and did not generate responsibility if there were reasonable grounds for such repudiation. Finally, host States' international responsibility would be determined in light of their good faith attempts to execute the legislation, which underlines the fact

145 *Id.* ¶ 94.

146 *Id.* ¶ 93 (italic in original).

that the failure to enforce does not immediately lead to responsibility for resulting damages to investors.

For these reasons host States' prerogatives whether or not to enforce their regulations remain broad, although they are not unfettered. Indeed, the *GAMI* award also favors investors in regard to a couple of important features: first, investors may still be compensated for damages caused by ex post lack of enforcement of regulation, if the above-mentioned conditions are met; and second, the *GAMI* award precludes host States from arguing the most expected excuses, such as costs, difficulty of the regulation, human resources constraints, and others, for abstaining from enforcing their own regulations.

#### **IV. INVESTMENT PROTECTION AND HOST STATES' EX POST CHANGES OF INTERPRETATION OF REGULATIONS EXISTING AT THE TIME OF THE INVESTMENT**

The final way in which host States can materially alter foreign investors' rights after they have made their investments is by changing the interpretation of the

regulation in place at that moment, to the detriment of the foreign investors. Indeed, a law comprises not only its general formal text, but also its understanding and application by host States in particular cases; and investors may rely on both the text and its interpretation when deciding whether to invest in a specific country. Consequently, changes in interpretation can have a critical impact on them.

On the other hand, from the host States' perspective, a particular statute confers different degrees of discretion to administrative agencies to determine how to apply it in real life situations. Sometimes the law is detailed and leaves little room for administrative involvement in its application; in others, the text is broad and gives administrative agencies leeway to make important decisions as to how the policies embodied in specific legislation will materialize. In either case, administrative agencies have room to apply legislation in a way that better reflects present social or governmental priorities, so it is of considerable importance for them to retain the freedom to alter their understanding of the law in response to changes in policies or priorities or to new realities. The

issue then is who must support the consequences associated with ex post changes of interpretation of legislation existing at the time of the investment. A dispute arising from the occurrence of such a change led to the awards in *Occidental Exploration and Production Company v. the Republic of Ecuador*<sup>147</sup> and *EnCana Corporation v. the Republic of Ecuador*.<sup>148</sup> Both concerned the same change of interpretation by Ecuador of a regulation in place at the time Occidental and EnCana invested in that country, but the tribunals took different approaches to this change. While the *Occidental* tribunal sought to protect investors' interest in legal stability in the face of host States' modifications of the understanding of existing law, considering them violations of the fair and equitable treatment

principle, the *EnCana* tribunal regarded mainly that good faith changes of interpretations should not engender international responsibility for wrongful expropriation.

### ***A. The Facts of the Occidental and EnCana Disputes***<sup>149</sup>

Occidental and EnCana's subsidiaries COL and AEC<sup>150</sup> signed Participation Contracts with Petroecuador for the exploration and production of oil.<sup>151</sup> The contracts included a clause labelled Factor X. This factor determined the share of the extracted oil that was to be assigned to the companies, and it was calculated so as to cover all costs of exploration and production in addition to granting a profit.<sup>152</sup>

147 Final Award in the Matter of an UNCITRAL ARBITRATION, London Court of International Arbitration. Administered Case No. UN 3463, *Occidental Exploration and Production Company v. the Republic of Ecuador*. July 1st, 2004 [hereinafter *Occidental award*]. (Members of the Tribunal: Francisco Orrego, Charles Brower, and Patrick Barrera), Available at [http://ita.law.uvic.ca/documents/Oxy-EcuadorFinalAward\\_001.pdf](http://ita.law.uvic.ca/documents/Oxy-EcuadorFinalAward_001.pdf).

148 Final Award in the Matter of an UNCITRAL ARBITRATION, London Court of International Arbitration, *EnCana Corporation v. the Republic of Ecuador*, February 3, 2006 [hereinafter *EnCana award*]. (Members of the Tribunal: James Crawford, Horacio Grigera Naón, and Christopher Thomas), available at <http://www.investmentclaims.com/oa1.html>). Horacio Grigera Naón dissented partially on grounds that will be detailed below. See Horacio Grigera Naón, *Partial Dissenting Opinion in the Matter of an UNCITRAL Arbitration between EnCana Corporation v. Republic of Ecuador*, December 30, 2005 [hereinafter *EnCana dissenting opinion*].

149 A detailed description of the facts of these disputes is somewhat complicated and goes beyond the scope of this article. Here will be described only the general factual situation that adequately presents Ecuador's change of interpretation of legislation.

150 COL and AEC were not Ecuadorian corporations and were constituted under the laws of a third State. See *EnCana award*, *supra* note 148, ¶ 115. Both companies were controlled by Pacalta Resources Limited, which was acquired by EnCana in May 1999. See *id.* ¶ 21.

151 Occidental and Petroecuador signed the Modified Participation Contract for the exploration and exploitation of hydrocarbons in Block 15 of the Ecuadorian Amazon Region on July 1, 1999. See *Occidental award*, *supra* note 147, ¶ 27. COL and Petroecuador signed a similar contract on March 29, 1995, and AEC and the Ecuadorian public entity concluded another contract of this nature on July 25, 1995. See *EnCana award*, *supra* note 148, ¶ 28. AEC entered into two additional Participation Contracts with Petroleum, an affiliate of Petroecuador on October 27, 1995, and on November 25, 1999. See *id.* ¶¶ 29 and 30.

152 See *Occidental award*, *supra* note 147, ¶ 96, and *EnCana award*, *supra* note 148, ¶¶ 31 and 32.

The contracts also contained an Economic Stability Clause, which would be triggered by changes in tax regulations, among other situations, and would lead to renegotiation of Factor X.<sup>153</sup>

Ecuador's general tax system included a provision pursuant to which exporters would receive a tax credit and/or a tax refund on the Valued Add Tax ("VAT") paid on the importation or purchases of inputs of products that were manufactured and exported.<sup>154</sup> No regulation of this type existed for the oil industry exclusively.<sup>155</sup> Pursuant to the general provision, the Internal Revenue Service (*Servicio de Rentas Internas, SRI*) granted Occidental and EnCana tax credits or refunds for goods and services imported or acquired as inputs for the production of oil until mid-

2001.<sup>156</sup> On August 28, 2001, SRI changed its interpretation of the relevant legislation<sup>157</sup> and denied Occidental's and the EnCana subsidiaries' respective individual applications for additional VAT refunds for prior months.<sup>158</sup> Subsequently, SRI adopted new resolutions requiring Occidental and EnCana's subsidiaries to reimburse the amounts corresponding to the tax credits initially granted.<sup>159</sup> The first main ground for the refusal and the request for reimbursement was initially that Factor X already included the VAT paid by companies.<sup>160</sup> Subsequently, the SRI added another basis, namely, that the oil industry did not manufacture goods or services, so it was not entitled to a VAT tax credit or refund.<sup>161</sup> Despite this argument, SRI had approved tax credits or tax refunds of VAT paid by industries

153 See Occidental award, *supra* note 147, ¶ 111 and EnCana award, *supra* note 148, ¶ 34.

154 One of the relevant provisions was Article 69A of the Ecuador Tax Law, which provides as follows:

VAT paid in export activities.- Natural persons and companies that have paid the value added tax in local purchases or importation of goods used in the manufacture of goods that are exported, have the right to have that tax refunded to them without interest within the period not to exceed ninety (90) days, through the issue of the respective credit note, check or other means of payment. ...

It is important to highlight that there was a considerable lack of clarity regarding the precise scope of the VAT refund, and multiple provisions were enacted and repealed in order to clarify the issue, without too much success. A detailed description of the state of Ecuador's tax law concerning VAT refunds and credits is presented in the Occidental award, ¶¶ 117 – 30, and in the EnCana award, ¶¶ 41 – 56.

155 The tribunal held that "during the course of this arbitration no specific laws or provisions pertaining to tax credits for oil activities have come to this Tribunal's attention." Occidental award, *supra* note 147, ¶ 133. See also the EnCana award, *supra* note 148, ¶ 51.

156 See Occidental award, *supra* note 147, ¶ 134.

157 The EnCana award includes a detailed description of this change of policy concerning the oil industry. See EnCana award, *supra* note 148, ¶¶ 63 – 72, and 85.

158 The denial regarding Occidental for the periods October-December 2000 and January-May 2001 was contained in SRI resolution No 664 of August 28, 2001. See Occidental award, *supra* note 147, ¶ 134. The denial of refunds to EnCana's subsidiaries was made by SRI Resolutions 669 and 670 of August 28, 2001. See EnCana award, *supra* note 148, ¶ 75.

159 The resolution requiring reimbursement of refunds granted to Occidental was issued on April 1, 2002. See Occidental award, *supra* note 147, ¶¶ 32 and 135. On this day, SRI issued another resolution with the same determination concerning one of EnCana's subsidiaries. See EnCana award, *supra* note 148, ¶ 82.

160 See Occidental award, *supra* note 147, ¶¶ 34 and 134. See EnCana award, *supra* note 148, ¶ 77.

161 See Occidental award, *supra* note 147, ¶ 135. See EnCana award, *supra* note 148, ¶ 83.

such as cut flowers, mining, lumber, bananas, and African palm oil.<sup>162</sup>

Finally, Ecuador enacted Interpretative Law No. 2004-41, which expressly provided that the refund of the VAT did not apply to petroleum activity.<sup>163</sup> However, this law did not affect the disputes insofar as they were related to facts that took place well before this enactment.

Given the *ex post* change of interpretation, Occidental sought a renegotiation of the contract with Petroecuador on the basis of the Economic Stability clause, but the State company declared that it could not renegotiate Factor X to include the VAT payments, because if it did so, Petroecuador would reduce Ecuador's share below the minimum level of oil allowed by Ecuadorian law.<sup>164</sup> Apparently, such an obstacle did not exist in the case of EnCana; Ecuador asked it to renegotiate, but EnCana refused.<sup>165</sup>

Unsatisfied with the SRI's change of interpretation and decisions, both Occidental and EnCana took Ecuador before the London Court of Arbitration, claiming that Ecuador had violated, respectively, the Treaty between the United States and Ecuador Concerning the Encouragement and Reciprocal Protection of Investment and the Canada-Ecuador Agreement for the Promotion and Reciprocal Protection of Investments. While Occidental prevailed in its dispute, EnCana did not. Differences in the text of the BITs, in the claimants and their claims, in the jurisdiction of both tribunals and in their assessment regarding *ex post* changes of interpretation of extant legislation explain such outcomes.

### ***B. The Findings and Conclusions of the Occidental Award***<sup>166 167</sup>

According to Occidental, Ecuador violated the obligations of the treaty related to fair and equitable treatment; national treatment; not

162 See Occidental award, *supra* note 147, ¶ 136.

163 See EnCana award, *supra* note 148, ¶ 95, 6.

164 See Occidental award, *supra* note 147, ¶ 114.

165 See EnCana award, *supra* note 148, ¶ 200 n.138, but see also ¶¶ 98, 99 for Ecuador's previous positions rejecting negotiations of the Participation Contracts with EnCana's subsidiaries.

166 The findings and conclusions of both the *Occidental* and *EnCana* awards regarding topics unrelated to the Host States' international responsibility for their subsequent change of interpretation of legislation extant at the time investors made their investments will be presented here.

167 One of the most debated issues of the *Occidental* dispute was that the tribunal did not have jurisdiction because the Ecuador-United States BIT established in Article X.2 that the dispute settlement system did not cover conflicts related to tax measures, save in the case of three situations, none of them at issue in the arbitral proceedings. The *Occidental* tribunal considered that, given that one of Ecuador's defenses was that the VAT was already being reimbursed through Factor X of the Participation Contract, the dispute involved arose out of a controversy between an investor and a Party regarding an investment contract, which, pursuant to Article X.2(c) of the BIT, could be resolved by the investor/State dispute settlement system of the treaty. For a complete description of the reasoning leading to the assertion of jurisdiction, see Occidental award, *supra* note 147, ¶¶ 66 – 77.

to impair the management, use and enjoyment of Occidental's investment through arbitrary measures; and not to totally or partially expropriate such investment.<sup>168</sup>

The tribunal evaluated, on the basis of the Participation Contract, the contentious issue of whether Factor X included refunds to Occidental for the payment of the VAT in the acquisition and importation of goods and services for the production of exported oil. The tribunal concluded that Factor X did not include a refund of the VAT<sup>169</sup> and went on to evaluate whether Occidental had a right under Ecuador's tax law to a refund of the VAT. The tribunal concluded that Occidental had such a right and stated:

[T]he Tribunal does not ... agree [with SIR] that the oil industry is excluded from the application of Article 69A, especially considering that Article 69A of the Tax Law Regulations establishes the right to a tax refund of VAT paid on purchases of goods and services for exporters irrespective of whether they be manufacturers or producers.<sup>170</sup>

Once the tribunal found that Occidental had a right to a VAT refund under Ecuadorian tax law, it moved on to assess Occidental's claims. Regarding the claim of violation of the principle of national treatment, the *Occidental* tribunal declared that Ecuador had not granted Occidental national treatment, because export companies in other industries in like circumstances, such as mining, bananas and others, had received refunds for the VAT paid.<sup>171</sup> The tribunal also held that Ecuador's Resolutions were not expropriatory measures or measures tantamount to expropriation contrary to Article III(1) of the BIT, because tax refunds did not qualify as investments under the U.S.-Ecuador BIT due to the fact that no company invests on tax refunds,<sup>172</sup> and even if tax refunds were investments, Ecuador's measures were not expropriatory since they did not affect "fundamental rights of ownership,"<sup>173</sup> because "there has been no deprivation of the use or reasonably expected economic benefit of the investment, let alone measures affecting a significant part of the investment..."<sup>174</sup>

168 *See id.* ¶ 35.

169 *See id.* ¶¶ 98 – 105, and 107.

170 *Id.* ¶ 136. The Tribunal had important support from an Ecuadorian Supreme Court ruling that arrived at the same conclusion, on the grounds that manufacturing comprised every kind of productive activity, and because the VAT depended on the final destination of the product and not on the source of the good. *See id.* ¶ 142. The Tribunal also considered that the oil industry was entitled to the refund of VAT on the basis of Andean Community Law. (*See id.* ¶ 145 – 8).

171 *See id.* ¶¶ 173 – 9.

172 *See id.* ¶ 86.

173 *Id.* ¶ 88.

174 *Id.* ¶ 89.

The *Occidental* tribunal determined that Ecuador had violated Article II(3)(a) of the U.S.-Ecuador BIT by failing to accord Occidental fair and equitable treatment, as will be seen below, and ordered Ecuador to give the company refunds of VAT equaling US. \$75 million, until December 31, 2003.<sup>175</sup> The tribunal declared that the resolutions requiring the devolution of the VAT refunds previously granted did not have a legal effect.<sup>176</sup>

### ***C. The Findings and Conclusions of the EnCana Award***

The *EnCana* tribunal did not hold Ecuador responsible for the damages caused to EnCana as a result of the former's change of interpretation of its tax law. It is important, however, to emphasize that the scope of evaluation of Ecuador's behaviour was narrower in the *EnCana* tribunal than in the *Occidental* tribunal due to the jurisdiction restriction of Article XII of the Canada-Ecuador BIT, which reads as follows:

1. Except as set out in this Article, nothing in this Agreement shall apply to taxation measures.
- ...
3. Subject to paragraph (2), a claim

by an investor that a tax measure of a Contracting Party is in breach of an agreement between the central government authorities of a Contracting Party and the investor concerning an investment shall be considered a claim of breach of this Agreement unless the taxation authorities of the Contracting Parties, no later than six months after being notified of the claim by the investor, jointly determine that the measure does not contravene such agreement.

4. Article VIII may be applied to a taxation measure unless the taxation authorities of the Contracting Parties, no later than six months after being notified by an investor that he disputes a taxation measure, jointly determine that the measure is not an expropriation.
5. If the taxation authorities of the Contracting Parties fail to reach the joint determinations specified in paragraphs (3) and (4) within six months after being notified, the investor may submit its claim for resolution under Article XIII.

The *EnCana* tribunal held that the SRI Resolutions denying EnCana's subsidiaries the refund of the VAT were taxation measures,<sup>177</sup> and any

<sup>175</sup> See *id.*, ¶ 212.

<sup>176</sup> See *id.*, ¶ 202.

<sup>177</sup> See *EnCana* award, *supra* note 148, ¶ 142.

discussion regarding whether the oil industry was or was not engaged in the manufacture of goods for export was a debate concerning a taxation measure and therefore beyond the jurisdiction of the tribunal.<sup>178</sup> The *EnCana* tribunal also pointed out that the fact that these SRI Resolutions were first grounded on the inclusion of refunds of VAT within the Factor X included in the Participation Contracts of EnCana's subsidiaries did not preclude the dispute from referring to a taxation measure.<sup>179</sup> On the other hand, contrary to the *Occidental* dispute, in which there was a disagreement concerning Ecuador and an investor regarding the breach of an investment agreement, the situation in the *EnCana* controversy was different, because EnCana's subsidiaries, being incorporated in a third country, did not qualify as investors pursuant to the Canada-Ecuador BIT<sup>180</sup>; therefore, Article XII(3) was not available to allow the tribunal to adjudicate claims related to fair and equitable treatment and national treatment.<sup>181</sup> For these reasons, the *EnCana* tribunal limited its jurisdiction to the claim of expropriation of the refund of the VAT, and its findings and conclusions will be analyzed below.<sup>182</sup>

## D. Investment Protection and Ex Post Changes of Interpretation of Existing Regulation in the Occidental and the EnCana Awards

### 1. The Pro-Investor Decision of the Occidental Award

As was mentioned, for the *Occidental* tribunal, the refund of the VAT was not included within Factor X of its Participation Contract; the refund was Occidental's right under Ecuadorian and Andean tax laws. According to the tribunal, the change of interpretation made by SRI in the resolutions denying further refund of the VAT and ordering the reimbursement of that previously granted constituted a violation of the fair and equitable treatment principle set forth in Article II (3)(a) of the U.S.-Ecuador BIT,<sup>183</sup> which provided:

Investment shall at all times be accorded fair and equitable treatment, shall enjoy full protection and security and shall in no case be accorded treatment less favorable than the required by international law.

The *Occidental* tribunal set forth the grounds of this conclusion:

178 See *id.* ¶¶ 145 and 146.

179 See *id.* ¶¶ 152 and 153.

180 See *id.* ¶¶ 109 and 167.

181 For a detailed account of the difference in the taxation exceptions provided for in the U.S.-Ecuador BIT and in the Canada-Ecuador BIT, see *id.* ¶ 167 n.119.

182 See *id.* ¶ 109.

183 See Occidental award, *supra* note 147, ¶ 187.

Although fair and equitable treatment is not defined in the Treaty, the Preamble clearly records the agreement of the parties that such treatment “is desirable in order to maintain a stable framework for investment and maximum effective utilization of economic resources.” The stability of the legal and business framework is thus an essential element of fair and equitable treatment.

The Tribunal must note in this context that the framework under which the investment was made and operates has been changed in an important manner by the actions adopted by the SRI. It was explained above that the Contract has been interpreted by SRI in a manner that ended up being manifestly wrong as there is no evidence of VAT reimbursement was ever built into Factor X. ... The tax law was changed without providing any clarity about its meaning and extent and the practice and regulations were also inconsistent with such changes. ...<sup>184</sup>

Equally important for the discussion of this article, and in striking contrast with the *EnCana*

award, as will be seen below, is the *Occidental* tribunal’s finding that, in assessing the SRI Resolutions, evaluations of good or bad faith on the part of Ecuador were not relevant. The tribunal stated:

It is quite clear from the record of this case ... that such requirements (of the fair and equitable principle) were not met by Ecuador. However, this is an objective requirement that does not depend on whether the Respondent has proceeded in good faith or not.<sup>185</sup>

Summing up, it can be inferred that, for the *Occidental* tribunal, host States’ ex post changes of interpretation of laws existing at the time investors made their investments, and harmful to them, are in themselves a breach of the fair and equitable treatment principle, because such changes go against the legal stability embodied in the principle, regardless of whether the changes are made in good faith.

## ***2. The Pro-Good Faith Host State Approach to Ex Post Changes of Interpretation and the EnCana Award***

184 *Id.* ¶ 183#, 4.

185 *Id.* ¶ 186. It is also important to mention that the *Occidental* tribunal, although it fell short of declaring that the SRI Resolutions were arbitrary measures, did consider that they had some degree of arbitrariness. The tribunal pointed out: In the context of the present dispute, the decisions taken by the SRI do not appear to have been found on prejudice or preference rather than on reason or fact. ... the SRI was confronted with a variety of practices, regulations and rules dealing with the question of VAT. It has been explained above that this resulted in a confusing situation into which the SRI had the task of bringing some resemblance of order. However, it is that very confusion and lack of clarity that resulted in some form of arbitrariness, even if not intended by the SRI. *Id.* ¶ 163.

The *EnCana* tribunal took a different approach when it evaluated whether the SRI Resolutions were expropriatory measures of EnCana's investments. Contrary to the *pro-investor* view adopted by the *Occidental* tribunal, it can be inferred from one of the main conclusions of the *EnCana* award that, to determine host States' international responsibility for wrongful expropriation, the question of whether they acted in good faith when they changed the understanding of their legislation must be taken into account.

Despite this difference in perspective of analysis, the *EnCana* tribunal shared an important aspect with the *Occidental* tribunal. In effect, the former considered, on the basis of the latter's assessment, that oil companies had indeed the right under Ecuadorian Law to a refund of the VAT.<sup>186</sup> However, contrary to the *Occidental* tribunal, and on the basis of the broad text of the term "investment" in Article I(g)(3) of the Canada-Ecuador BIT, the *EnCana* tribunal held that refunds of VAT qualified as investments.<sup>187</sup>

Although these two findings would suggest that Ecuador's denial of refunds of the VAT to EnCana would

lead to international responsibility the tribunal delved deeper into the facts of the case and deemed that, at the time of the signing of the Participation Contracts, the Ecuadorian tax legislation was not clear as to whether the oil industry was entitled to refunds of the VAT. The tribunal held:

[I]n the periods immediately prior to and following the conclusion of the Participation Contracts, according to the literal text of the legislation it was not clear whether all exporters were entitled to a VAT tax credit in relation to input VAT associated with acquisition or importation of raw materials under Article 65 of the ITRL. Although Article 163 of the Regulations appeared to envisage entitlement to a credit as a matter of general principle, Article 169 of the Regulations only expressly granted the right to a credit to exporters involved in manufacture (*fabricacion*). It was also not entirely clear under what circumstances there was an entitlement to a refund under Article 163 of the Regulations, rather than merely the setting off of a tax credit against future liabilities.<sup>188</sup>

It is then consistent with this finding that, for the *EnCana* tribunal, the claimant's legitimate

186 See *EnCana* award, *supra* note 148, ¶ 189.

187 See *id.* ¶ 183.

188 *Id.* ¶ 48.

expectations depended not on the text of the Ecuadorian tax law,<sup>189</sup> but on whether EnCana's subsidiaries had received refunds of the VAT at the time that EnCana acquired these companies. The tribunal pointed out that in the dispute there was no "question of the denial of the legitimate expectation as to tax treatment; [because] at the time the investments were made, no claim to VAT refunds was being asserted or allowed."<sup>190</sup>

After having regarded tax refunds as investment, the tribunal then turned to the claim of direct expropriation, as was mentioned.<sup>191</sup> In rejecting this claim, the *EnCana* tribunal sided with Ecuador, because the State had acted in good faith, an element that played a pivotal role in the tribunal's determination.<sup>192</sup> It reasoned:

In terms of the BIT the executive is entitled to take a position in relation to claims put forward by individuals, even if that position may turn out

to be wrong in law, provided it does so in good faith and stands ready to defend its position before the courts. Like private parties, governments do not repudiate obligations merely by contesting their existence. An executive agency does not expropriate the value represented by a statutory obligation to make a payment or refund by mere refusal to pay, provided at least that (a) the refusal is not merely willful, (b) the courts are open to the aggrieved private party, (c) the courts' decisions are not themselves overridden or repudiated by the State.

This principle applies equally to tax authorities as to other executive agencies. In the Tribunal's view, the policy of a tax authority such as SRI is not reviewable under Article VIII of the BIT ... unless that policy in itself amounts to an actual and effective repudiation of legal rights.

Turning to the facts of the case, even if SRI may have been looking for reasons to deny VAT recovery

189 It is important to recall that there was no specific law regulating VAT refunds for the oil industry, so any expectation arose from the general law applicable to all exporting industries. For the *EnCana* tribunal, investors' reliance on this law was not sufficient to create a legitimate expectation.

190 *Id.* ¶ 200 n.138. This finding was contested by the dissenting member of the tribunal, for whom "[E]nCana and its subsidiaries were justified in legitimately expecting that under Ecuadorian Law the latter's activities and revenue and the former's investment returns were not to be burdened by VAT, as it was the case in respect of other non-manufacturing sectors of the Ecuadorian economy." *EnCana* dissenting opinion, *supra* note 148, ¶ 41. See also ¶ 63 and 64.

191 EnCana claimed first that the Resolutions affecting it were indirect expropriation because they constituted "unreasonable interference with the ability of the Claimant and the Companies to make use of and benefit from their economic entitlements". (*EnCana* award, *supra* note 148, ¶ 177). The *EnCana* tribunal dismissed this claim (*See id.* ¶ 178) by stating that "[o]nly if a tax is extraordinary, punitive in amount or arbitrary in its incidence would issues of indirect expropriation be raised. In the present case, in any event, the denial of VAT refunds in the amount of 10% of transactions associated with oil production and export did not deny EnCana "in whole or significant part" the benefits of its investment." (*Id.* ¶ 177).

192 The tribunal held that this finding of good faith was "crucial to the Tribunal's analysis. Had it been found that the authorities acted in bad faith the analysis would have led to a finding of State responsibility ..." *Id.* ¶ 200 n.138.

to oil companies, in the Tribunal's view this was tempered in a number of ways. In particular:

- a the oil companies could and did challenge SRI's rulings in the courts, on occasions with success;
- b when it lost, SRI complied promptly with the court decisions;
- c EnCana itself did not challenge Dr de Mena's good faith, and the Tribunal, having heard Dr de Mena, accepts that she was indeed acting in good faith in a matter where the legal issues were unclear and unsettled;
- d There is no evidence ... that the court decisions were partisan biased against oil companies or otherwise non-independent. Indeed, the differences of opinion between the Tax Court and the Supreme Court suggest the contrary.

For these reasons in the period prior to November 2004, SRI's policy on oil refunds never rose to the level of the repudiation of an Ecuadorian legal right; it did not

therefore amount to a violation of Article VIII.<sup>193</sup>

Equally relevant for the host States' perspectives are the other requirements contained in the *EnCana* award, in particular, the availability of domestic courts and the host States' compliance with adverse domestic rulings. These requirements were severely criticized by the dissenting member, who saw them as a requisite to exhaust domestic remedies.<sup>194</sup> For him, such requirements were unnecessary, since the tribunal could resolve the case irrespective of the determinations of national courts. He stated:

[T]he local laws, administrative acts and practices and other conduct attributable to the host State at the moment they had the effect of operating the deprivation of property, are *facts* to be freely evaluated by the arbitrators to determine if the foreign investor's entitlement to protection under international law has been infringed at a specific moment of time or not. An international tribunal enjoys

193 *Id.* ¶ 194-97. The dissenting member strongly disagreed with this conclusion. For him, Ecuador's measures were expropriatory (*See EnCana* dissenting opinion, *supra* note 148, ¶ 71, 73 & 74) because, by virtue of them, EnCana had to resort to the renegotiation process of Factor X in order to seek, through this means, the reimbursement of VAT paid, (*See id.* ¶ 61) and this process could not achieve EnCana's goal. For this member of the tribunal, the remedy offered to EnCana was "in fact a covert way of refusing any meaningful remedy at all." (*Id.* 65). The arbitrator concluded that "[b]y ... denying a clear and unconditional remedy providing such legal entitlement [the tax refund] with any real or apparent teeth, since there is no guarantee that the negotiation process will or may succeed, or that the economic value of such entitlement will not end up by being diluted in the negotiation process ... Ecuador has deprived EnCana's subsidiaries of rights to the payment of money amounts that negatively affect and substantially erode EnCana's rights to investment returns ... that are covered by the Treaty and protected under its Article VIII.1 in case of expropriation." (*Id.* 69).

194 *See EnCana* dissenting opinion, *supra* note 148, ¶ 8. The tribunal denied this objection. *See EnCana* award, *supra* note 148, ¶ 200 n.138.

discretion – to be reasonable exercised – to evaluate at which moment such conduct, considered as a fact ... has acquired sufficient level of gravity, permanence or irrevocability – as well as harmful effects – to constitute a treaty violation, and such discretion is not controlled ... by determinations of local courts under their own laws.”<sup>195</sup>

In conclusion, the *EnCana* tribunal’s finding could be seen as a ruling that favors host States’ powers to make ex post changes of interpretation of legislation existing at the time investments were made. The tribunal produced this effect, first, by limiting the legitimate expectations that investors may have regarding interpretations of the law when they make their investments. For the *EnCana* tribunal, legitimate expectations are restricted only to those host States’ interpretations expressly related to the given company prior to the time when the investment was made in it. Consequently, interpretations of the law that have been applied to companies in similar industries would not generate legitimate expectations for other investors, so any ex post change of these interpretations would be immune

from the affected investors’ claims, thereby broadening host States’ power to make such subsequent interpretations without risk.

Second, for the *EnCana* tribunal, ex post changes of interpretation of regulation existing at the time the investment was made will lead to international responsibility for wrongful expropriation of foreign investors’ investments only if it is willful, and in bad faith.<sup>196</sup> So, good faith ex post changes in the understanding of the law would be safe from investors’ claim of expropriation. This finding assigns host States a good degree of discretion to exert their power to subsequently change their interpretation of the extant law, be it tax law or legislation in other fields, at the time of the investment, when there are valid reasons to do so.

Finally, from the host States’ perspective, these two features of the *EnCana* award would suffice to broadly protect their power to adopt ex post changes to the understanding of the extant legislation. To require, in practical terms, investors to claim their rights before domestic courts first is, in this author’s view, unnecessary

<sup>195</sup> *EnCana* dissenting opinion, *supra* note 148, ¶ 12. *See* also in this regard ¶ 24, 26 and 27.

<sup>196</sup> Despite the fact that this *EnCana* tribunal’s conclusion was made in regard to Host States’ tax prerogatives, in which they have a broad latitude, the generalization is still possible to cover changes in interpretation in other areas, because the tribunal itself stated that its findings were applicable not only to tax authorities but also to “other executive agencies.” *See EnCana* award, *supra* note 148, ¶ 195.

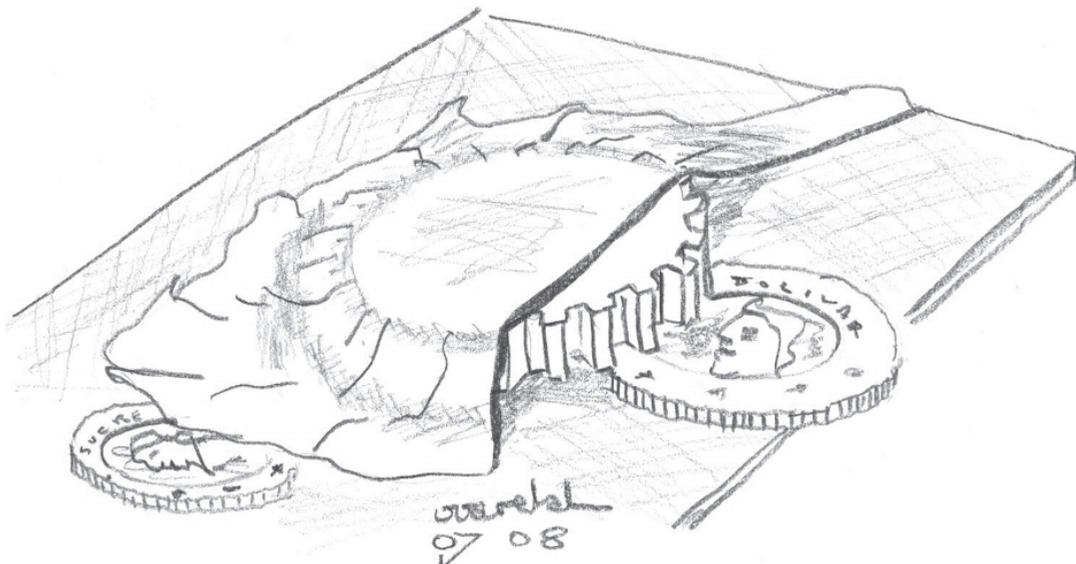
within the framework of BITs, one of whose main characteristics is to offer swift dispute settlement through international arbitration tribunals. The dissenting member's legal reasoning in this regard is well grounded, and it remains to be seen whether the related *EnCana* award's findings will be persuasive for future arbitration tribunals, given such strong opposition from within.

***E. Could the EnCana Awards Regarding Ex Post Changes of Interpretation of Extant Legislation Be Applied to Claims of Violation of the Fair and Equitable Principle?***

Given the significance that the *EnCana* award could have for host States if applied by other international tribunals facing similar disputes, and recalling that the findings and conclusions of this

award refer to investors' claim of violation of BITs for wrongful expropriations, it would be in the host States' interest to determine whether some of these findings could also be applied to disputes in which a host State's ex post change of interpretation of extant legislation is claimed to violate the fair and equitable principle consecrated in a BIT.

Host States would need such an analysis for two reasons: first, there could be cases in which the dispute stems from ex post changes of interpretation that do not affect a previous right but that create a new obligation, so that the injured investor's claim is a violation of the fair and equitable principle. If the dispute is one of this sort, host States would most likely try to expand the scope of the *EnCana* award to counterbalance the investor's reliance



on the *Occidental* award and its plea for legal stability. The same could be said of disputes in which the ex post change of interpretation affects an investor's right without expropriating it, and the claim the investor makes is the violation of the fair and equitable treatment principle.

To begin with, one of the findings of the *EnCana* award that host States would surely invoke in subsequent disputes, in which the fair and equitable treatment principle is argued to have been violated as a result of an ex post change of interpretation, is the scope of legitimate expectations created in investors by the interpretations existing at the time of the investment. The *EnCana* tribunal took a very restricted view in this regard, as was seen, and this view—which undeniably benefits host States—could also be applied to the analysis of this situation under the said principle.

One of the main effects of this extension would be to limit the risk of ex post changes of interpretations being considered as violations of the fair and equitable principle owed by host States to foreign investors. Indeed, the larger the ambit of the legitimate expectations, the higher the possibility of finding a violation of

the fair and equitable treatment principle by ex post changes of interpretation of legislation existing at the time of the investment and vice versa.

This sole finding of the *EnCana* tribunal, if adopted by future arbitration tribunals, would favor the cause of host States by reducing, to an important extent, the risk of considering the adoption of ex post changes in the interpretation of legislation as a violation of the fair and equitable treatment principle. Nonetheless, it remains to be seen whether such a restricted view of legitimate expectations prevails in the future under these circumstances, given that arbitration tribunals dealing with a dispute of this character would have to evaluate the expansion of this finding of the *EnCana* award within the context of the fair and equitable treatment principle in light of the *Occidental* award and its *pro-investor* approach favoring legal stability as a cornerstone of this principle.

The second finding of the *EnCana* award that host States would like to see applied to the assessment of their ex post changes of interpretation of extant legislation in light of the fair and equitable treatment principle would be whether the ex post change was

made in good faith by the given State. This would be so, because host States' good faith has proved to be an important element for other arbitration tribunals, such as *Waste Management* and *GAMI*, to conclude that the given State did not violate the fair and equitable treatment principle. On the other hand, attempting to introduce host States' good faith in these circumstances would serve to offset, as was mentioned, the investors' invocation of the *Occidental* award, which did not take into account such an element at all.

The single reference the *EnCana* tribunal made to the fair and equitable principle provided for in Article II of the Ecuador-Canada BIT could suffice to introduce host States' good faith among the elements to be judged by arbitral tribunals determining whether an ex post change of interpretation of regulations existing at the time of the investment infringes upon this principle. The *EnCana* award states: In the Tribunal's view it could well be a breach of Article II of the BIT for a State entity such as Petroecuador, having negotiated the terms of the investment agreement on a certain basis, subsequently to deny the other party the right to renegotiate in

accordance with the agreement in the event that the basis for it has been changed as a result of decisions of other State organs. Under standards such as those in Article II of the BIT the State must act with reasonable consistency and without arbitrariness in its treatment of investments. One arm of the State cannot finally affirm what another arm denies to the detriment of a foreign investor. But this claim is not made by *EnCana*, which never requested renegotiation...<sup>197</sup>

From this passage, one could argue that an ex post change of interpretation of extant legislation would not imply by itself a violation of the fair and equitable treatment principle. This would be so because the *EnCana* tribunal speaks of "reasonable consistency" and lack of "arbitrariness"; therefore, in addition to proving the change of interpretation, there would be a requirement to allege its lack of reasonableness and its arbitrariness, which could mean that, if the change of interpretation is made in good faith by the given host State, it could well qualify as a reasonable change that could render the State immune from any responsibility for violation of the fair and equitable treatment principle.

<sup>197</sup> *Id.* ¶ 158.

In sum, while the need to ensure stability for investors was the key element of the *Occidental* award, and the failure to ensure this stability led the tribunal to hold Ecuador responsible for violation of the fair and equitable principle, the cornerstone of the *EnCana* award is the host State's good faith when changing its interpretation, and the presence of this good faith led the latter tribunal to exonerate Ecuador from wrongful expropriation. Regarding changes of interpretation of regulation existing at the time the investment was made, the emphasis of the *Occidental* tribunal was on investors, while that of the *EnCana* tribunal was on host States. Future arbitration tribunals will determine, on the basis of the specific facts at issue, which of the two approaches, or what combination of the two, will prevail.

## V. GENERAL CONCLUSIONS

The above-mentioned international arbitration awards come to important conclusions for foreign investors and host States that should be taken into account when the latter face the decision of whether to adopt ex post regulations that could potentially affect foreign investors or when the former evaluate their rights under BITS in light of the adoption

of any of the situations that materially involved the adoption of ex post normativity.

Regarding ex post regulations enacted to respond to grave economic crises, the *CMS* case gave an important boost to investors by preserving the intangibility of their rights under such extreme circumstances and by always ensuring that investors had the right to claim compensation for losses generated by the emergency regulation. Although the *CMS* award insisted that foreign investors must bear some part of the burden of the crisis, on balance, the prerogatives they may receive as a result of this award cause them to bear, in reality, a lighter burden than that borne by the host States suffering such emergencies.

The balance is the opposite concerning the adoption of ex post general environmental regulations. In the *Methanex* award, host States retained great powers to adopt them. Not only does this award allow States to more easily establish differences between domestic investors and foreign investors in like circumstances, but also, the exercise of their ex post regulatory power leads to international responsibility only if the State made specific commitments that it would

not adopt the given regulation. The *Methanex* award mostly preserved these powers.

In regard to host States' international responsibilities for the ex post lack of application or lack of enforcement of the regulation existing at the time the investment was made, the *GAMI* tribunal favoured mostly States, by imposing a heavy burden of proof on investors to succeed in a claim of this type and by also judging the States' omission in light of their good faith attempts to enforce the given regulation. Despite this broad host States' prerogative, the fact is that it is not unfettered and such

lack of enforcement could eventually lead to international responsibility.

Finally, concerning ex post changes of interpretation of legislation existing at the time the investment was made, foreign investors could well use the *Occidental* award to hold States liable for such changes on the basis of a violation of the fair and equitable treatment principle, regardless of the host States' good faith, while host States could find their power to change interpretations supported by the *EnCana* award, if the given change is made in good faith and it is not merely willful.

