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Stephan W. Schill
NYU Law School

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New York University School of Law
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Fair and Equitable Treatment under Investment Treaties as an Embodiment of the Rule of Law

Stephan W. Schill, NYU Law School [*]

Abstract

Fair and equitable treatment is emerging as one of the core concepts of international investment protection and is frequently invoked and applied in investor-state dispute settlement under bilateral and multilateral investment treaties. The frequency with which it is applied and the expansive interpretation given to it by arbitral tribunals contrasts, however, with a lack of clarity concerning the principle's normative content. This raises salient questions about the accountability of investment tribunals and the legitimacy of the jurisprudence they develop. The paper proposes to understand fair and equitable treatment as an embodiment of the rule of law. It shows that the jurisprudence of investment tribunals on fair and equitable treatment can be summarized under a primarily institutional and procedural concept of the rule for law that has parallels in the major domestic legal systems of liberal democracies and argues that such an understanding can be normatively grounded in the objective of international investment treaties.

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[*] Hauser Global Scholar (New York University School of Law, 2005/2006), First and Second Legal State Exam (Bavaria, 2001, 2003), LL.M. in European and International Economic Law (Universität Augsburg, 2002), LL.M. International Legal Studies (New York University, 2006). I hereby gratefully acknowledge financial support for the preparation of this article by the Studienstiftung des Deutschen Volkes/European Recovery Program and the Hauser Foundation.

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I. Introduction

The International Centre for Settlement of Investment Disputes (ICSID) has been established some forty years ago by the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID Convention).[1] Only during the past decade, however, has investor-state dispute settlement under the Convention surged due to the rise and increasingly frequent invocation of breaches of bilateral and multilateral investment treaties.[2] Given above all the widespread criticism investor-state dispute settlement is facing in regard of its restrictive effect on host state law- and policy-making, it is also time to develop more conceptual frameworks with respect to the substantive law contained in international investment treaties. Among other factors, the criticism seems to stem to a large extent from the considerable vagueness of many standard guarantees in international investment treaties[3] and the perception that their interpretation by investment tribunals is unpredictable and comprises the risk of inconsistent or even contradictory interpretation.[4] In this context, commentators frequently allude to a "legitimacy crisis" in investment arbitration.[5]

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1 575 U.N.T.S. 159.

2 See, on the statistical development of investment treaty arbitration, United Nations Conference on Trade and Development (UNCTAD), *Investor-State Disputes Arising from Investment Treaties: A Review*, pp. 3 *et sqq.* (2005); available at http://www.unctad.org/en/docs/iteiit20054_en.pdf. See generally, on international investment treaties, Dolzer/Stevens, *Bilateral Investment Treaties* (1995); Lowenfeld, *International Economic Law*, 474 *et sqq.* (2002); Sornarajah, *The International Law of Foreign Investment*, 315 *et sqq.* (2nd ed. 2004); Sacerdoti, *Bilateral Treaties and Multilateral Instruments on Investment Protection*, 269 Recueil des Cours 251 (1997); Salacuse, *BIT by BIT: The Growth of Bilateral Investment Treaties and their Impact on Foreign Investment in Developing Countries*, 24 International Lawyer 655 (1990).

3 See only Soloway, *NAFTA's Chapter 11: The Challenge of Private Party Participation*, 16 J. Int'l Arb. 1, 3 (1999) (arguing that the "lack of clarity in Chapter 11 prevents the establishment of a secure and stable framework for investments"); Ferguson, *California's MTBE Contaminated Water: An Illustration of the Need for an Environmental Interpretative Note on Article 1110 of NAFTA*, 11 Colo. J. Int'l Envt'l L. & Pol'y 499, 503 (2000) (noting that the "vague language" of NAFTA allows for an "abuse" of investor-state dispute resolution); Beauvais, *Regulatory Expropriations Under NAFTA: Emerging Principles and Lingering Doubts*, 10 N.Y.U. Envt'l L. J. 245, 257-58 (2001-2002); Poirier, *The NAFTA Chapter 11 Expropriation Debate Through the Eyes of a Property Theorist*, 33 Environmental Law 851, 902 et sqq. (2003); Been/Beauvais, *The Global Fifth Amendment? NAFTA's Investment Protections and the Misguided Quest for an International "Regulatory Takings" Doctrine*, 78 N.Y.U. L. Rev. 30, 125 et sqq. (2003) (all noting the vagueness of the expropriation standard under international law); Porterfield, *An International Common Law of Investor Rights?*, 27 U. Pa. J. Int'l Econ. L. 79 (2006) (arguing that fair and equitable treatment due to its vagueness cannot constitute a legitimate norm of international law); Garcia, *All the Other Dirty Little Secrets: Investment Treaties, Latin America, and the Necessary Evil of Investor-State Arbitration*, 16 Fla. J. Int'l L. 301, 350 (2004) (referring to "the vague and unbounded notions of fair and equitable treatment and full protection and security").

4 Franck, *The Legitimacy Crisis in Investment Treaty Arbitration: Privatizing Public International Law Through Inconsistent Decisions*, 73 Fordham L. Rev. 1521, 1558 et sqq. (2005).

5 Brower, *A Crisis of Legitimacy*, Nat'l L. J., Oct. 7, 2002; Afilalo, *Towards a Common Law of International Investment: How NAFTA Chapter 11 Panels Should Solve Their Legitimacy Crisis*, 17 Geo. Int'l Envt'l L. Rev. 51 (2004); Franck (supra note 4), 73 Fordham L. Rev. 1521 (2005).

While initially the protection of foreign investors against indirect expropriations has been the focus of much political and academic debate,[6] more recently another key guarantee of international investment treaties is coming to the fore in the on-going struggle over the appropriate scope of international investment protection: the standard of fair and equitable treatment. Being attested to have "the potential to reach further into the traditional 'domaine réservé' of the host state than any one of the other rules of [investment] treaties",[7] fair and equitable treatment is emerging as one of the core concepts governing the relationship between foreign investors and host states in international investment law. The standard appears prominently in almost all of the approximately 2400 bilateral investment treaties (BITs) as well as regional and multilateral investment treaties, such as Art. 1105(1) of the North American Free Trade Agreement (NAFTA) and Art. 10(1) of the Energy Charter Treaty (ECT), prior to that figured in the Friendship, Commerce and Navigation Treaties the U.S. concluded with various countries and played a role in all multilateral projects relating to the protection of foreign investment.[8]

Despite its textual presence in various international legal instruments over a period of over 60 years, fair and equitable treatment has for a long time received surprisingly little attention in academic literature and in the practice of international courts and tribunals. Over the past five years, however, fair and equitable treatment has emerged as a central element on the grounds of which host states are increasingly often ordered to pay damages to foreign investors in disputes before international arbitral tribunals. Yet, the frequency with which it is invoked by foreign investors and applied as a basis for state responsibility by arbitral tribunals contrasts with an astonishingly fundamental lack of conceptual understanding about the principle's normative content. Given that fair and equitable treatment undoubtedly constitutes a legal standard, not an empowerment of arbitral tribunals to render decisions *ex aequo et bono*,[9] the tribunals are faced with the task to

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6 Dolzer, *Indirect Expropriation: New Developments?*, 11 N.Y.U. Envt'l L. J. 64 (2002-2003); Been/Beauvais (supra note 3), 78 N.Y.U. L. Rev. 30 (2003); Brunetti, *Indirect Expropriation in International Law*, 5 Int'l L. FORUM du droit int. 150 (2003); Dolzer/Bloch, *Indirect Expropriation: Conceptual Realignments?*, 5 Int'l L. FORUM du droit int. 155 (2003); Fortier/Drymer, *Indirect Expropriation in the Law of International Investment: I know It When I See It, or Caveat Investor*, 19 ICSID Rev. — Foreign Inv. L. J. 293 (2004); Yannaca-Small, *"Indirect Expropriation" and the "Right to Regulate" in International Investment Law*, OECD Working Papers on International Investment, Number 2004/4, available at http://www.oecd.org/dataoecd/22/54/33776546.pdf [all websites visited last on July 11, 2006]; Kunoy, *Developments in Indirect Expropriation Case Law in ICSID Transnational Arbitration*, 6 J. World Inv. & Trade 467 (2005); Newcombe, *The Boundaries of Regulatory Expropriation*, 20 ICSID Rev. – Foreign Inv. L. J. 1 (2005).

7 Dolzer, *The Impact of International Investment Treaties on Domestic Administrative Law*, 38 N.Y.U. J. Int'l L. & Pol. (2006) (forthcoming).

8 See on the history of the fair and equitable treatment standard Vasciannie, *The Fair and Equitable Treatment Standard in International Investment Law and Practice*, 70 Brit. Yb. Int'l Law 99 (1999); Yannaca-Small, *Fair and Equitable Treatment Standard in International Investment Law*, OECD Working Papers on International Investment, Number 2004/3, p. 3 et sqq., available at http://www.oecd.org/dataoecd/22/53/33776498.pdf.

9 See Yannaca-Small (supra note 8), p. 40; Schreuer, *Fair and Equitable Treatment in Arbitral Practice*, 6 J. World Inv. & Trade 357, 365 (2005); see also *Case Concerning Oil Platforms (Islamic Republic Of Iran v. United States Of America) – Preliminary Objection*, ICJ Judgment of Dec. 12, 1996, ICJ Reports 1996, 803 et sqq., Separate Opinion by Judge Higgins, par. 39.

enrich this admittedly vague standard with concrete normative content in order to apply it to the factual circumstances submitted to them.

Although the language of the various investment treaties is not uniform, varying above all between a plain prescription of fair and equitable treatment and a combination of the standard with an explicit reference to international law or the customary international minimum standard,[10] it is questionable whether substantial differences result from the different framing of the standard with a view to the actual practice of investment tribunals. This has become apparent in particular in the NAFTA context where Art. 1105(1) has to be interpreted – pursuant to a binding interpretation by NAFTA's Free Trade Commission under Art. 1131(2) – in accordance with customary international law.[11] Two factors, in particular, level possible differences between treaty law and custom. First, some tribunals held that the inclusion of fair and equitable treatment in the vast web of international investment agreements has transformed the standard itself into customary international law.[12] Secondly, even absent such an explicit transformation, other tribunals interpret the international minimum standard as an evolutionary concept that has evolved since the days of traditional international law concerning the treatment of aliens.[13] This evolutionary interpretation also levels differences between treaty law and custom concerning the fair and equitable treatment standard.

This paper attempts to contribute to the on-going debate on rule- and decision-making of investment tribunals with a specific view to the tribunals' construction and application of fair and equitable treatment. The task in the context of this paper does, however, not consist in exhaustively describing the facts of each case and the conclusions drawn by arbitral tribunals; the arbitral jurisprudence on fair and equitable treatment has been accurately and extensively discussed in a number of scholarly contributions.[14] Instead, the paper focuses on outlining the elements arbitral

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10 See Dolzer, *Fair and Equitable Treatment: A Key Standard in Investment Treaties*, 39 Int'l Law. 87, 90 (2005) (explaining that the plain approach prevails in the treaty practice of Germany, the Netherlands, Sweden and Switzerland, whereas the bilateral investment treaties of France, the United Kingdom and the United States generally make reference to international law). See also UNCTAD, *Fair and Equitable Treatment*, p. 10 et sqq. (1999), available at http://www.unctad.org/en/docs/psiteiitd11v3.en.pdf.

11 NAFTA Free Trade Commission, *Notes of Interpretation of Certain Chapter 11 Provisions*, 31 July 2001, available at http://www.dfait-maeci.gc.ca/tna-nac/NAFTA-Interpr-en.asp.

12 See for example *Pope & Talbot*, UNCITRAL, Award in Respect of Damages of May 31, 2002, par. 62; similarly *Mondev International Ltd. v. The United States of America*, ICSID Case No. ARB(AF)/99/2, Award of Oct. 11, 2002, par. 125 [all investment awards are, unless explicitly stated otherwise, available via http://www.investmentclaims.com]; see also Hindelang, *Bilateral Investment Treaties, Custom and a Healthy Investment Climate – The Question of Whether BITs Influence Customary International Law Revisited*, 5 J. World Inv. & Trade 789 (2004).

13 See *Pope & Talbot* (supra note 12), par. 58 et sqq.; *Mondev v. United States* (supra note 12), par. 125; *ADF Group Inc. v. United States*, ICSID Case No. ARB(AF)/00/1, Final Award of Jan. 9, 2003, par. 179; see also Choudhury, *Evolution or Devolution? – Defining Fair and Equitable Treatment in International Investment Law*, 6 J. World Inv. & Trade 297 (2005).

14 See for recent attempts to sum up the jurisprudence Yannaca-Small (supra note 8), p. 13 et sqq.; Choudhury (supra note 13), 6 J. World Inv. & Trade 297 (2005); Schreuer (supra note 9), 6 J. World Inv. & Trade 357 (2005); Dolzer (supra note 10), 39 Int'l Law. 87 (2005).

tribunals attribute to fair and equitable treatment in a more conceptual way and attempts to provide a general framework of analysis for the standard's application and interpretation.

In Part II, the paper takes a critical look at the way arbitral tribunals interpret and apply fair and equitable treatment and points to some shortcomings in the arbitral jurisprudence resulting mainly from the standard's considerable vagueness. Part III subsequently aims at clarifying the normative content of fair and equitable treatment and outlines a methodology for the application of fair and equitable treatment to the circumstances of a case submitted to arbitration. This should promote the predictability and uniformity of the standard's interpretation and thus its acceptance by states and investors.

The paper shows how international tribunals have developed certain sub-elements of fair and equitable treatment that appear in recurrent fashion in arbitral jurisprudence and argues that these elements can be understood as and united under the concept of the rule of law (*Rechtsstaat* in the German, *état de droit* in the French tradition). The underlying assumption of such an approach is that the fair and equitable treatment standard has an independent and genuine normative content that is different from other rights granted in international investment treaties. Understanding fair and equitable treatment in such a fashion attributes to the standard a quasi-constitutional function that serves as a yardstick for the exercise of host states' administrative, judicial or legislative activity vis-à-vis foreign investors. In this perspective, the arbitral jurisprudence does not appear as a fragmented and disordered aggregate of awards but as an expression of the continuous emergence of a global regime that governs foreign investment and the conduct of host states relating to it. Conceptualizing fair and equitable treatment as an embodiment of the rule of law mainly relies on a comparative public law approach that takes a cross-view of the restrictions of governmental activity in domestic legal systems that embrace the concept of the rule of law.

Conversely, the appropriate methodology for concretizing fair and equitable treatment the paper suggests, consists in a comparative method that attempts to extract general principles from domestic legal systems and other international legal regimes that embrace an institutional design prescribing rule of law standards for the exercise of governmental power in administrative and judicial proceedings and legislation. At the same time, a comparative approach to fair and equitable treatment illustrates the tension between the rule of law as a legal value and competing public interests that requires a proportionate balance. It underscores that fair and equitable treatment cannot be understood as an absolute guarantee but rather as a principle that allows for a balance between investment protection and the host state's public interest.

This understanding of fair and equitable treatment can, however, not only be used as a conceptual explanation of the bulk of the arbitral jurisprudence, but can be grounded in the normative framework contained in international investment treaties, above all the treaties' object and purpose. Part IV therefore provides an analysis of the economics of international investment treaties and shows the positive effects the adoption of the concept of the rule of law has on the

behavior of foreign investors, thus promoting foreign investment and economic growth in host countries.

II. Shortcomings in Arbitral Practice Relating to Fair and Equitable Treatment

Arbitral tribunals seem generally ill-equipped in tackling the interpretative conundrum posed by the vagueness of the fair and equitable treatment standard. Tribunals do not only regularly criticize that the standard is not further defined and clarified in investment agreements,[15] they have also not achieved to develop a uniform methodology in order to determine whether specific host state conduct violates fair and equitable treatment.[16] The main reason for this is that traditional interpretative approaches applying Art. 31 and 32 of the Vienna Convention on the Law of Treaties,[17] either directly or as an expression of the customary international law of treaty interpretation,[18] are hardly able to clarify the meaning of fair and equitable treatment. The vagueness of the standard goes beyond the commonplace assertions in legal theory that law is inherently vague and indeterminate when it comes to the application of abstract standards to concrete cases. Vagueness and indeterminacy of fair and equitable treatment are not a matter of the penumbra of a rule in the *Hartian* sense or the edges of the rule's frame in the *Kelsenian* sense, but concern the very core of the provision. It does not have a consolidated and conventional core meaning that can easily be applied. Apart from consensus on the fact that fair and equitable treatment constitutes a standard that is independent from the domestic legal order and does not require actions in bad faith by host states,[19] it is hardly substantiated by state practice or elucidated by *traveaux preparatoires* and difficult to narrow down by traditional means of interpretation.

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15 See *Alex Genin, Eastern Credit Limited, Inc. and A. S. Baltoil v. Republic of Estonia*, ICSID Case No ARB/99/2, Award of June 25, 2001, par. 367: "the exact content of this standard is not clear"; *Consortium RFCC v. Royaume du Maroc*, ICSID Case No. ARB/00/6, Sentence Arbitrale of Dec. 22, 2003, par. 51: "*Il n'existe pas de définition précise du traitement just et équitable dans le droit des traités*"; *Ronald S. Lauder v. The Czech Republic*, UNCITRAL, Award of Sept. 2, 2001, par. 292: "*[T]here is no further definition of the notion of fair and equitable treatment in the Treaty.*"; *CMS Gas Transmission Company v. The Republic of Argentina*, ICSID Case No. ARB/01/8, Award of May 12, 2005, par. 273: "*The Treaty, like most bilateral investment treaties, does not define the standard of fair and equitable treatment.*"

16 Criticizing the lack of a uniform methodology for example Kantor, *Fair and Equitable Treatment: Echoes of FDR's Court-Packing Plan in the International Law Approach Towards Regulatory Expropriation, The Law and Practice of International Courts and Tribunals* (Summer 2006) (forthcoming).

17 U.N. Doc. A/CONF.39/27 (1969), 1155 U.N.T.S. 331.

18 See only *Case Concerning the Territorial Dispute (Libyan Arab Jamahiriya/Chad)*, Judgment of Feb. 13, 1994, I.C.J. Reports 1994, 21, par. 41; *Case Concerning Oil Platforms (Islamic Republic of Iran v. United States of America)*, Judgment of Dec. 12, 1996, ICJ Reports 1996, 803, par. 23; *Case Concerning Kasikili/Sedudu Island (Botswana v. Namibia)*, Judgement of Dec. 13, 1999, ICJ Reports 1999, 1045 par. 18.

19 Concerning the independence of fair and equitable treatment from domestic law Dolzer (supra note 10), 39 Int'l Law. 87, 88 (2005); on the independence from bad faith Schreuer (supra note 9), 6 J. World Inv. & Trade 357, 384 et seq. (2005).

An interpretation of the ordinary meaning may replace the terms "fair and equitable" with similarly vague and empty phrases such as "just", "even-handed", "unbiased" or "legitimate",[20] but does not succeed in clarifying its normative content.[21] In particular, the semantics of fair and equitable treatment do not clarify as against which standard "fairness and equitableness" has to be measured. It could equally refer to notions of equality or substantive justice, or to less grand notions of procedural due process.

Likewise, a plain teleological interpretation hardly provides more specific meaning even if the purpose of international investment treaties points to the protection and promotion of foreign investment and the deepening of the mutual economic relations between the contracting states.[22] Although this narrows down the possible understandings of fair and equitable treatment to an economic framework, a purposive interpretation does not enable tribunals to directly translate the broad language into specific guarantees for foreign investors in the sense of hard and fast rules. In particular, it is difficult to foresee and estimate whether a specific interpretation of an international investment treaty will actually encourage investment flows or whether, on the contrary, an interpretation that may be too onerous for host states will have the effect of chilling the investment climate due to host states admitting less foreign investment.[23]

The traditional methods of treaty interpretation therefore prove to be relatively ineffective in clarifying the meaning of fair and equitable treatment. Understandably, investment tribunals do not follow a uniform methodology.[24] Some tribunals follow an approach that extensively describes the facts of a case and simply characterizes them as a violation of fair and equitable treatment.[25] The problem with this approach is that it does not elucidate the normative content of fair and equitable treatment and leaves the legal reasoning underlying the decision in the obscure. Other tribunals simply posit an abstract standard as part of fair and equitable treatment and subsequently subsume the facts of the case under this standard.[26] While this is closer to the traditional legal syllogism, the

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20 Compare *MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile*, ICSID Case No. ARB/01/7, Award of May 25, 2004, par. 113.

21 It rather confirms that a terminological approach does not succeed in substantiating and clarifying what fair and equitable refers to. In this sense *Saluka Investments BV v. The Czech Republic*, UNCITRAL, Partial Award of Mar. 17, 2006, par. 297; differently Dolzer (supra note 10), 39 Int'l Law. 87, 88 (2005).

22 See on the object and purpose if investment treaties and the statements contained in the preambles of investment treaties Dolzer/Stevens, *Bilateral Investment Treaties*, p. 11 et sqq., 20 et sqq. (1995).

23 Accordingly, the Tribunal in *Noble Ventures, Inc. v. Romania*, ICSID Case No. ARB/01/11, Final Award of Oct. 12, 2005, par. 52 warned that a teleological interpretation should not simply lead to an interpretation of bilateral investment treaties *in dubio pro investorem*: "While it is not permissible, as is too often done regarding BITs, to interpret clauses exclusively in favour of investors, here such an interpretation is justified." (emphasis added).

24 See Dolzer (supra note 10), 39 Int'l Law. 87, 93 et seq. (2005) (discerning the three lines of reasoning subsequently addressed).

25 See for example *Mondev v. United States* (supra note 12), par. 118, stressing that "[a] judgment of what is fair and equitable cannot be reached in the abstract; it must depend on the facts of the particular case".

26 See for example *S.D. Myers, Inc. v. Government of Canada*, UNCITRAL, Partial Award of Nov. 13, 2000, par. 134.

tribunals nevertheless fail to properly justify how they ground these abstract standards in fair and equitable treatment. Finally, various tribunals apply fair and equitable treatment with a strong reference to prior arbitral jurisprudence.[27] This approach is critical in two respects. First, treating arbitral decisions as precedent in international law is problematic;[28] secondly, the awards face the criticism that earlier decisions have themselves applied a problematic methodology in terms of failing to grasp the normative content of fair and equitable treatment.

By failing to establish a clear normative, i. e. prescriptive, content of fair and equitable treatment, arbitral tribunals run the risk of facing the reproach that they handle the standard as a malleable tool of *ex post facto* control of host states' measures based on the arbitrators' personal conviction and understanding about what is fair and equitable. The assumption that personal convictions, instead of prescriptive legal standards, play a major role in applying fair and equitable treatment is nourished by the frequent reference to treatment that "shocks, or at least surprises, a sense of juridical propriety"[29] as a yardstick for the standard's application.[30]

Similarly, legal scholarship has not provided much conceptual guidance.[31] Like arbitral tribunals, commentators have not developed a definition or a methodological tool for concretizing fair and equitable treatment. Above all, they have not attempted to unite the vast jurisprudence under a comprehensive concept in order to give a fuller normative explanation of the standard's content. Mostly, they concede that no agreement on the exact meaning of the principle exists[32] and

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27 See for example *Waste Management, Inc. v. The United Mexican States*, ICSID Case No. ARB(AF)/00/3, Award of 30 April 2004, par. 89 et sqq.

28 Under general international law no doctrine of *stare decisis* exists, see Artt. 38(1)(d) and 59 of the Statute of the International Court of Justice; see also Verdross/Simma, *Universelles Völkerrecht*, p. 395 et sqq. (3rd ed. 1984). This general observation also holds true in the investment arbitration context. Explicitly in this sense Art. 1136(1) NAFTA: "An award made by a Tribunal shall have no binding force except between the disputing parties and in respect of the particular case." See also Schreuer, *The ICSID Convention: A Commentary*, Art. 53 par. 15 (2001) (noting that in the preparatory works for the ICSID Convention nothing implies the applicability of a *stare decisis* rule). Art. 53(1) ICSID-Convention that provides that "[t]he award shall be binding on the parties […]" can therefore be read as "binding *only* on the parties".

29 See for example *Tecnicas Medioambientales Tecmed S. A. v. The United Mexican States*, ICSID Case No. ARB(AF)/00/2, Award of May 29, 2003, par. 154 quoting the decision of the International Court of Justice in *Elettronica Sicula S.p.A. (ELSI) (United States of America v. Italy)*, Judgment of July 20, 1989, ICJ Reports 1989, p. 15, par. 128. See for a criticism of the ICJ's test for arbitrariness in the *ELSI* case Hamrock, *The* ELSI *Case: Toward an International Definition of "Arbitrary" Conduct*, 27 Tex. Int'l L. J. 837, 849 et sqq. (1992) (highlighting the prevalence of subjective elements in the Court's test)

30 See UNCTAD (supra note 10), p. 10 (noting the "inherently subjective" trait of the concepts of fairness and equitableness); see also Yannaca-Small (supra note 8), p. 2 et seq. (mentioning the concern of "a number of governments […] that, the less guidance of provided for arbitrators, the more discretion is involved and the closer the process resembles decisions *ex aequo et bono, i.e* based on the arbitrators' notions of "fairness" and "equity").

31 See also Thomas, *Reflections on Art. 1105 NAFTA: History, State Practice and the Influence of Commentators*, 17 ICSID Rev. – Foreign Inv. L. J. 21, 51 et sqq (2002). (warning to attach too much weight to the opinions of commentators).

32 Dolzer (supra note 10), 39 Int'l Law. 87, 88 (2005) (noting that "a review of some attempts at defining the standard may invite such thinking inasmuch as the approach is so general in nature that the clause may appear to amount to a catch-all provision which may embrace a very broad number of governmental acts."); Schreuer

largely confine themselves to describing the existing case law in order to extract contextual elements of fair and equitable treatment[33] or attribute to it the function of a gap-filling device for judging host state conduct that cannot be subsumed under other, possibly more precise, investment treaty guarantees.[34] Some commentators therefore suggest that fair and equitable treatment constitutes "an intentionally vague term, designed to give adjudicators a quasi-legislative authority to articulate a variety of rules necessary to achieve the treaty's object and purpose in particular disputes".[35] Similarly, other commentators support the view that the interpretative problems posed by the principle's vagueness should be solved by simply letting tribunals do the work in developing more precise elements of fair and equitable treatment.[36]

It is, however, questionable whether states intended such a broad delegation of powers to international tribunals.[37] In addition, shifting the responsibility of concretizing the meaning of fair and equitable treatment to arbitral tribunals is problematic. It does not only fail to meet the need for further guidance regularly uttered by some tribunals themselves. More importantly, it is unsatisfactory from the perspective of host states that need to evaluate the way they exercise public authority without having to pay damages for the violation of investment treaties.[38] Likewise, it is unsatisfactory from the perspective of foreign investors who desire a stable and predictable investment climate and need to know beforehand against which political risks and government interference they are protected by the respective investment treaty. Unpredictable or worse arbitrary

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(supra note 9), 6 J. World Inv. & Trade 357, 364 (2005); Choudhury (supra note 13), 6 J. World Inv. & Trade 297, 298 (2005).

33 Schreuer (supra note 9), 6 J. World Inv. & Trade 357, 364 et sqq. (2005) (stressing the specific fact situations considered as a violation of fair and equitable treatment); Choudhury (supra note 13), 6 J. World Inv. & Trade 297, 316 et seq. (2005) (providing a working definition of fair and equitable treatment that relies on the acceptance of several sub-elements of the standard in arbitral jurisprudence); see also Thomas (supra note 31), 17 ICSID Rev. – Foreign Inv. L. J. 21, 59 et sqq (2002); Sornarajah, *The International Law of Foreign Investment*, p. 332 et sqq. (2nd ed. 2004).

34 Dolzer (supra note 10), 39 Int'l Law. 87, 90 (2005). Similarly Mann, *British Treaties for the Promotion and Protection of Investments*, 52 Brit. Yb. Int'l L 241, 243 et seq. (1981) (understanding fair and equitable as an "overriding duty").

35 Brower, *Investor-State Disputes under NAFTA: The Empire Strikes Back*, 40 Columb. J. Transnat'l L. 43, 56 (2003). Similarly Franck (supra note 4), 73 Fordham L. Rev. 1521, 1589 (2005) (arguing that the interpretative openness of fair and equitable treatment may be better than "over-definition"); Vandevelde, *United States Investment Treaties: Policy and Practice*, p. 76 (1992). See also Dolzer (supra note 10), 39 Int'l Law. 87, 89 (2005) (suggesting that states deliberately included this general standard as a gap-filling clause).

36 See for example Schreuer (supra note 9), 6 J. World Inv. & Trade 357, 365 (2005) (explaning that fair and equitable treatment "is susceptible of specification through judicial practice".); Dolzer (supra note 10), 39 Int'l Law. 87, 105 (2005) (concluding that the task with respect to fair and equitable treatment is "developing a body of jurisprudence tailored to the specific structures of foreign investment and acceptable to investors, the host state and the home state".)

37 Porterfield (supra note 3), 27 U. Pa. J. Int'l Econ. L. 79, 103 et sqq. (2006). For the contrary view see supra note 35.

38 Alternatively, host states may even abstain from regulation due to this insecurity. International investment treaties would then result in a "regulatory chill", possible even in areas where regulation is not only necessary but possible even in the interest of foreign investors. In this sense see Franck, *Occidental Exploration & Production Co. v Republic of Ecuador*, 99 A.J.I.L. 675, 678 (2005).

outcomes of arbitration proceedings will not only dissatisfy the parties involved, but may overall chill the efficiency of investment arbitration and the promotion of foreign investment.

A missing conceptual understanding of fair and equitable treatment may also lead to inconsistent decisions in the field of investment protection, possibly lessening the stability and predictability necessary for foreign investment and fostering the fragmentation of international investment law. A theoretic approach to the normative content of fair and equitable treatment may, therefore, not only clarify the conceptual foundations of the standard but is also crucial in order to generate a sustainable understanding of the rights and obligations of investors and host states that are critical to the very basis of international investment protection. With respect to fair and equitable treatment a clearer delineation between investors' rights and state sovereignty is thus needed.

III. Fair and Equitable Treatment as an Embodiment of the Rule of Law

In this chapter the paper presents an attempt to provide a normative framework of analysis for the interpretation and application of fair and equitable treatment. The argument forwarded is that fair and equitable treatment should properly be understood as an embodiment of the concept of the rule of law (or *Rechtsstaat* in the German, *état de droit* in the French tradition). The rule of law is a wide-spread positive legal concept that can be found with similar characteristics in most legal systems that adhere to liberal constitutionalism.[39] Relying on a common tradition,[40] the main thrust of the rule of law is the aspiration to subject public power to legal control[41] and can be paraphrased accurately with the words of *F. A. Hayek*: "stripped of all technicalities this means that government in all its actions is bound by rules fixed and announced beforehand – rules which make it possible to foresee with fair certainty how the authority will use its coercive powers in given circumstances, and to plan one's individual affairs on the basis of this knowledge".[42]

The rule of law primarily refers to the formal quality of law as providing guidance for human affairs and comprises the institutional aspiration that government has to use law as a means of exercising power.[43] First, the rule of law translates into procedural requirements for the deployment

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39 See Schulze-Fielitz, in: Dreier (ed.), *Grundgesetz – Kommentar*, Art. 20 par. 5 et sqq. (vol. II 1998).

40 See on the development of the rule of law in its politico-philosophical background Tamanaha, *On the Rule of Law – History, Politics, Theory* (2004).

41 Dyzenhaus, *The Rule of (Administrative) Law in International Law*, 68 Law & Contemp. Prob. 127, 130 (2005); similarly Waldron, *Is the Rule of Law an Essentially Contested Concept (in Florida)?*, 21 Law & Philosophy 137, 158 (2002); Hesse, *Der Rechtsstaat im Verfassungssystem des Grundgesetzes*, in: Forsthoff (ed.), *Rechtsstaatlichkeit und Sozialstaatlichkeit*, p. 557, 560 et sqq. (1968). As such, it should also be distinguished from other concepts of good and desirable government, such as human rights, democracy or justice. See Raz, *The Rule of Law and its Virtue*, 93 L. Quart. Rev. 195 et seq. (1977).

42 Hayek, *The Road to Serfdom*, p. 54 (1944).

43 See Fallon, *"The Rule of Law" as a Concept in Constitutional Discourse*, 97 Columb. L. Rev. 1, 14 et sqq. (1997) on the formalist ideal in the rule of law.

of legal processes[44] and mandates that "individuals whose interests are affected by the decisions of […] officials have certain rights", such as "the right to a hearing before a decision is made, the right to have the decision made in an unbiased and impartial fashion, the right to know the basis of the decision so that it can be contested, the right to reasons for the official's decision, and the right to a decision that is reasonably justified by all relevant legal and factual considerations."[45] Hence, the rule of law requires that the affected individual is recognized as a subject with certain rights which have to be taken into account in the decision making process of public authorities. In addition to the recognition of procedural rights, the rule of law is often also at the origin of the idea of proportionality, referring to the proper balance that has to be struck between the interests of the individual and competing public interests.[46] Secondly, the rule of law has implications for the institutional design of government. It mandates a basic separation of powers and the possibility to seek review of public acts by an independent judiciary.[47] Essentially it is this primarily formal understanding of the rule of law that prevails in many domestic legal traditions.[48]

In this sense, fair and equitable treatment can be understood as a rule of law standard that the legal systems of host states have to embrace as a standard for the treatment of foreign investors. While this may not seem much of a concretization given different historic developments and thrusts of the rule of law in different national legal systems and in light of the fact that the exact content and the requirements of the rule of law are often debated,[49] it nevertheless seems to constitute a viable approach to explain the normative content of fair and equitable treatment. A comparative analysis of municipal law reveals certain common ideas and standards that can be transferred to the international level. And help to identify the paradigm features a state has to conform to in order to comply with the notion of "fairness and equitableness" in international investment law. Arguably, a comparative approach also suggests a suitable methodological approach for the standard's interpretation and renders the outcome of investment disputes more predictable.

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44 See Fallon (supra note 43), 97 Columb. L. Rev. 1, 18 et sqq. (1997) on the legal process ideal understanding of the rule of law.

45 Dyzenhaus (supra note 41), 68 Law & Contemp. Prob. 127, 129 (2005).

46 See on this thrust that has been developed particularly in the German tradition and has been taken up in the reasoning of the European Court of Human Rights and the European Court of Justice infra note 112.

47 Dyzenhaus (supra note 41), 68 Law & Contemp. Prob. 127, 130 et seq. (2005).

48 See on the primarily formal tradition in Germany for example Schulze-Fielitz (supra note 39), Art. 20 par. 13 et sqq. Similarly, the due-process clause of the US Constitution has mainly found a procedural interpretation; see Shell, *Rechtsstaatlichkeit und Demokratie in den USA*, in: Tohidipur (ed.), *Der bürgerliche Rechtsstaat*, p. 377 et sqq. (1978). See also Kantor (supra note 16) on the decline of the substantive understanding of due process by the Supreme Court and the emphasis on procedure.

49 See only Waldron (supra note 41), 21 Law & Philosophy 137 (2002).

A. Overarching Principles Derived from Fair and Equitable Treatment

In view of the existing arbitral jurisprudence on fair and equitable treatment, seven specific normative elements can be discerned that occur in recurring fashion in the reasoning of arbitral tribunals and are presented as elements of fair and equitable treatment. These elements are (1) the requirement of stability, predictability and consistency of the legal framework, (2) the principle of legality, (3) the protection of investor confidence or legitimate expectations, (4) procedural due process and denial of justice, (5) substantive due process or protection against discrimination and arbitrariness, (6) the requirement of transparency and (7) the requirement of reasonableness and proportionality. These elements also figure prominently as sub-elements or expressions of the broader concept of the rule of law in domestic legal systems.

1. Stability, Predictability, Consistency

International investment treaties in general seek to enhance the stability of the investment climate and reduce political risk.[50] Accordingly, one aspect that is recurrently invoked by investment tribunals as part of fair and equitable treatment is the concept of stability, predictability and consistency of the host state's legal framework. Based on the preamble in the U.S.-Argentine BIT that provides "that fair and equitable treatment of investment is desirable in order to maintain a stable framework for investment and maximum effective utilization of economic resources", the Tribunal in *CMS v. Argentina*, for example, found that "there can be no doubt […] that a stable legal and business environment is an essential element of fair and equitable treatment".[51] On this basis, the Tribunal found that the Argentine emergency legislation in 2001/2002 entirely and permanently transformed the legal framework of the privatized gas sector and thus violated fair and equitable treatment.[52] Likewise, the Tribunal in *OEPC v. Ecuador* held that "[t]he stability of the legal and business framework is thus an essential element of fair and equitable treatment".[53]

Similarly, the predictability of the legal framework governing the activity of foreign investors is frequently considered as an element of fair and equitable treatment. The Tribunal in *Metalclad v. Mexico*, for instance, based its finding of a violation of Art. 1105(1) NAFTA *inter alia* on the argument that Mexico "failed to ensure a […] predictable framework for Metalclad's business

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50 Rubins/Kinsella, *International Investment, Political Risk and Dispute Resolution*, p. 1 et sqq. (2005). See also *CMS Gas Transmission Company v. The Republic of Argentina*, ICSID Case No. ARB/01/8, Decision on Objections to Jurisdiction of June 17, 2003, par. 28 (regarding bilateral investment treaties as one of the "expressions of the search for stability and legal certainty" in international economic relations).

51 *CMS v. Argentina* (supra note 15), par. 274.

52 See for more a fuller analysis of the case Schill, *From Calvo to CMS: Burying an International Law Legacy – Argentina's Currency Reform in the Face of Investment Protection: The ICSID Case CMS v. Argentina*, 3 SchiedsVZ/German Arb. J. 285 (2005).

53 See *Occidental Exploration and Production Company v. The Republic of Ecuador*, LCIA Case No. UN3467, Final Award of July 1, 2004, par. 183.

planning and investment".[54] The predictability of the legal framework was also evoked by the Tribunal in *Tecmed v. Mexico* when stressing that the foreign investors needs to "know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices and directives, to be able to plan its investment and comply with such regulations".[55] Accordingly, a lack of clarity of the legal framework or are excessively vague rules can violate fair and equitable treatment.[56]

Finally, the concept of consistency plays an important role in the arbitral jurisprudence on fair and equitable treatment. The Tribunal in *Lauder v. Czech Republic*, for example, stressed this connection when it underscored that fair and equitable treatment could be violated if domestic agencies acted inconsistently in applying domestic legislation.[57] Similarly, in *MTD v. Chile* the Tribunal found a violation of fair and equitable treatment due to "the inconsistency of action between two arms of the same Government *vis-à-vis* the same investor".[58] Likewise, the Tribunal in *Tecmed v. Mexico* emphasized the need of consistency in the decision-making of a national agency in order to conform to fair and equitable treatment.[59]

These lines of argument run parallel to one of the central elements the concept of the rule of law is associated with in domestic legal systems: legal certainty and legal security (*Rechtssicherheit*).[60] This element of the rule of law refers to the core aspect of normativity of law that allows individuals to adapt their behavior to the requirements of the legal order and form stable social relationships. Especially in the commercial context stability is a critical component for long-term investment. Legal security requires a certain stability of the legal order, legal certainty calls for predictable and understandable rules and their consistent application. This interpretation notably conforms with the object and purpose of international investment treaties, as stability, predictability

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54 See *Metalclad Corporation v. The United Mexican States*, ICSID Case No. ARB(AF)/97/1, Award of Aug. 30, 2000, par. 99.

55 *Tecmed v. Mexico* (supra note 29), par. 154.

56 See for example *Occidental Exploration v. Ecuador* (supra note 53), par. 184 criticizing the vagueness of a change in the domestic tax law that did not "provid[e] any clarity about its meaning and extent".

57 *Lauder v. Czech Republic* (supra note 15), par. 292 et sqq. In the case at hand, a regulatory agency had commenced an administrative proceeding against a television broadcasting company for non-compliance with the domestic Media Law due to allegedly unauthorized broadcasting without the necessary license. The Tribunal declined to find a violation of fair and equitable treatment by arguing that there were understandable grounds why the agency had initiated administrative proceedings. It also pointed out that inconsistent conduct of domestic agencies could not be assumed if the conduct consisted in enforcing domestic law, unless there was a specific undertaking to the effect of refraining from doing so.

58 *MTD v. Chile* (supra note 20), par. 163.

59 *Tecmed v. Mexico* (supra note 29), par. 154, 162 et seq. See also *Occidental Exploration v. Ecuador* (supra note 53), par. 184.

60 As such it is recognized, mostly as a constitutional standard, in many domestic legal systems. See for its implementation in the German Constitution Schulze-Fielitz (supra note 39), Art. 20 par. 117 et sqq.; see Fallon (supra note 43), 97 Columb. L. Rev. 1, 14 et sqq. (1997) for references on U.S. constitutional practice; more generally also see Raz (supra note 41), 93 L. Quart. Rev. 195, 198 (1977).

and consistency are necessary for investors in order to plan and calculate their investment and adjust to the legal framework in the host country.

Yet, one has to be aware that stability and predictability of domestic law can only relate to the normal deployment of governmental law- and policy-making and, parallel to the function of the rule of law in domestic constitutional law, should not be understood as an absolute requirement that would allow foreign investors to be effectively excluded from regulatory changes in the host state.[61] Accordingly, stability and predictability should not be misunderstood as a guarantee that the legal framework will never change or even serve as business guarantees to investment projects.[62] Likewise, the stability of the legal order will vary with the circumstances host states might have to react to: a serious crisis or even an emergency situation may call for different reactions than the deployment of public power in the normal course of things.[63] Concerning consistency, one should be aware that domestic regulatory frameworks are never completely free of inconsistencies.[64] A violation of this sub-element should therefore be handled in a prudent manner.

2. Legality

Fair and equitable treatment has also been interpreted by arbitral tribunals as including the principle of legality. In various cases tribunals based their assessment of fair and equitable treatment on an appreciation of whether domestic actors obeyed national legal provisions governing the conduct in question. Although tribunals diverge on the question to which extent the correct application is subject to scrutiny by arbitral tribunals, their jurisprudence is consistent in holding that a violation of domestic law can constitute a violation of fair and equitable treatment.[65] This obligation applies to the domestic judiciary as well as to administrative agencies, and has even been

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61 In this sense also Dolzer (supra note 10), 39 Int'l Law. 87, 105 (2005).

62 See only *Emilio Agustín Maffezini v. The Kingdom of Spain*, ICSID Case No. ARB/97/7, Award of Nov. 13, 2000, par. 64 ("emphasiz[ing] that Bilateral Investment Treaties are not insurance policies against bad business judgments"); *Marvin Roy Feldman Karpa v. The United Mexican States*, ICSID Case No. ARB(AF)/99/1, Award of Dec. 16, 2002, par. 112 (noting "that not every business problem experienced by a foreign investor is an indirect or creeping expropriation under Article 1110, or a denial of due process or fair and equitable treatment under Article 1110(1)(c).")

63 See for example the *ELSI Case* (supra note 29), par. 74: "Clearly the right [to control and manage a company] cannot be interpreted as a sort of warranty that the normal exercise of control and management shall never be disturbed. Every system of law must provide, for example, for interferences with the normal exercise of rights during public emergencies and the like."

64 Franck (supra note 38), 99 A.J.I.L. 675, 678 (2005).

65 Although some tribunals held that a violation of domestic law in itself is not a violation of fair and equitable treatment, such as *ADF v. United States* (supra note 13) (stressing explicitly that "something more than simple illegality or lack of authority under the domestic law of a State is necessary to render an act or measure inconsistent with the customary international law requirements of Article 1105(1)"), I rather do not interpret this as requiring an additional or qualified violation of domestic law but instead see this as a question of the standard of review of international tribunals that may depend on the procedural posture of the case, the applicable law, the question whether local remedies were exhausted etc.

alluded to concerning the question whether the activity of the domestic legislator was in conformity with the national constitution.[66]

In *Metalclad v. Mexico*, for instance, one factor for the Tribunal's finding of a violation of fair and equitable treatment was the apparent misapplication of a construction law by a local municipality.[67] Similarly, in *Pope & Talbot v. Canada* the Tribunal relied on the lack in competence of a domestic agency for initiating administrative proceedings against a foreign investor. Instead of relying "on naked assertions of authority and on threats that the Investment's allocation could be cancelled, reduced or suspended for failure to accept verification", the Tribunal emphasized that "before seeking to bludgeon the Investment into compliance, the SLD [i. e. the administrative agency] should have resolved any doubts on the issue and should have advised the Investment of the legal basis for its actions", instead of relying "on naked assertions of authority and on threats that the Investment's allocation could be cancelled, reduced or suspended for failure to accept verification".[68] Here, the failure to show a legal basis for the administrative proceedings under domestic law was therefore taken into account as one aspect for the violation of fair and equitable treatment.

Fair and equitable treatment was also interpreted to include an obligation to apply domestic law. In *GAMI Investments, Inc. v. Mexico* the Tribunal deduced from fair and equitable treatment an obligation to not only abide by but also to enforce existing provisions of national law.[69] Similarly, in *Tecmed v. Mexico* the Tribunal underscored that host states have make use of "the legal instruments that govern the actions of the investor or the investment in conformity with the function usually assigned to such instruments".[70]

The connection between fair and equitable treatment and the principle of legality does, however, not only become apparent when domestic decision-makers violate municipal laws. On the contrary, the observance of domestic legal rules is often relied upon by tribunals in order to deny a violation of fair and equitable treatment. In *Noble Ventures, Inc. v. Romania*, for example, the Tribunals observed that certain bankruptcy proceedings "were initiated and conducted according to the law and not against it"[71] and accordingly denied a violation of fair and equitable treatment. Similarly, in *Lauder v. Czech Republic* the tribunal emphasized that a violation of fair and equitable

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66 See *CMS v. Argentina* (supra note 15), par. 119 et sqq.

67 *Metalcald v. Mexico*, par. 93.

68 *Pope & Talbot, Inc. v. The Government of Canada*, UNCITRAL, Award on the Merits of Phase 2 of April 10, 2001, par. 174 et seq.

69 *GAMI Investments, Inc. v. The United Mexican States*, UNCITRAL, Final Award of Nov. 15, 2004, par. 91: "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."

70 *Tecmed v. Mexico* (supra note 29), par. 154.

71 *Noble Ventures v. Romania* (supra note 23), par. 178.

treatment was usually excluded for a "regulatory body taking the necessary actions to enforce the law".[72]

The decisions therefore clearly consider the principle of legality as an element of fair and equitable treatment. The principle of legality also finds its counterpart in rule of law concepts that encompass the requirement that public power derives its authority from a legal basis and is exercised along the lines of pre-established legal procedural and substantive rules.[73] The principle of legality should, however, not distract from the fact that fair and equitable treatment does not simply buttress the application of domestic law and provide a claim of the foreign investor against the host state to apply its domestic law correctly. Rather, fair and equitable treatment remains an independent standard of international law against which the domestic legal order is measured.

3. Protection of Confidence and Legitimate Expectations

While the principle of legality is closely related to the idea that the executive and the judicial branch of government have to obey the law enacted by the legislator, legal rules are only able to have a stabilizing function for social relationships and create the basis of an environment conducive to long-term investment when they are applied according to how a reasonable investor would expect them to be applied. The ordering function of law therefore requires taking into account the perceptions of the law's subject and their expectations vis-à-vis government activity.

Accordingly, the concept of legitimate expectations is emerging as another prominent sub-element of fair and equitable treatment in arbitral practice. The Tribunal in *Saluka v. Czech Republic* referred to the concept of legitimate expectations even as "the dominant element of that standard".[74] Its existence can also be traced as an element of the rule of law in domestic legal systems[75] and as a concept of general international law.[76] Its main thrust in this context is the protection of confidence against administrative and legislative conduct. In this sense, the Tribunal in *Tecmed v. Mexico* held that fair and equitable treatment requires "provid[ing] to international investments treatment that does not affect the basic expectations that were taken into account by the

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72 *Lauder v. Czech Republic* (supra note 15), par. 297.

73 In the German constitutional tradition this element of the rule of law is designated as "Gesetzmäßgkeit der Verwaltung" und "Vorrang des Gesetzes". See Schulze-Fielitz (supra note 39), Art. 20 par. 83 et sqq.

74 *Saluka v. Czech Republic* (supra note 21), 301.

75 See Dyzenhaus (supra note 41), 68 Law & Contemp. Prob. 127, 133 et sqq. (2005) with reference to case law in Australia and the UK; Schulze-Fielitz (supra note 39), Art. 20 par. 134 et sqq. concerning German Constitutional Law; Schønberg, *Legitimate Expectations in Administrative Law* (2000) on English, French and EC/EU law; Dyer, *Legitimate Expectations in Procedural Fairness after Lam*, in: Groves (ed.), *Law and Government in Australia*, p. 184 et sqq. (2005) on Australian law; see also Woehrling, *Le Principe de Confiance Légitime dans la Jurisprudence des Tribunaux*, in: Bridge (ed.), *Comparative Law Facing the 21st Century*, p. 815 et sqq. (1998) summarizing a comparative study by the XVth International Congress of Comparative Law, Bristol/UK in 1998.

76 See Müller, *Vertrauensschutz im Völkerrecht* (1971). See more specifically in the context of the law on expropriations of aliens Dolzer, *New Foundations of the Law of Expropriation of Alien Property*, 75 A.J.I.L. 553, 579 et seq. (1981).

foreign investors to make the investment".[77] Similarly, the Tribunal in *International Thunderbird Gaming Corporation v. Mexico* explained the concept of legitimate expectations as restricting government activity when "a Contracting Party's conduct creates reasonable and justifiable expectations on the part of an investor (or investment) to act in reliance on said conduct, such that a failure by the NAFTA Party to honour those expectations could cause the investor (or investment) to suffer damages."[78]

Legitimate expectations can result from a number of actions that are attributable to the host state.[79] In the first place, a breach of legitimate expectations will come into play if there is conduct "in breach of representations made by the host State which were reasonably relied on by the [investor]".[80] They can result, for example, from opinions and statements released by administrative agencies about the application of domestic law.[81]

It is, however, not necessary that expectations were induced by administrative action that was individually directed towards a foreign investor. Legitimate expectations can also originate from the provisions of the general regulatory framework a host state has set in place[82] as long as the confidence the framework generates is sufficiently specific. In this context, the concept of legitimate expectation as an element of the rule of law may even restrict the domestic legislator in its decision-making concerning the change of the regulatory framework. This was the case in the

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77 *Tecmed v. Mexico* (supra note 29), par. 154. The Tribunal's approach was also taken up in a number of other cases. See *ADF v. United States* (supra note 13), par. 189; *MTD v. Chile* (supra note 20), par. 114 et seq.; *Occidental Exploration v. Ecuador* (supra note 53), par. 185; *CMS v. Argentina* (supra note 15), par. 279; *Eureko B.V. v. Republic of Poland*, Partial Award of Aug. 19, 2005, par. 235, 241.

78 *International Thunderbird Gaming Corporation v. The United Mexican States*, Arbitral Award of Jan. 26, 2006, par. 147 (internal citation omitted).

79 See on the connection between the expectations and government conduct *ADF v. United States* (supra note 13), par. 189, where the Tribunal declined to find a violation of Art. 1105(1) NAFTA in a case where the claimant argued that existing case law suggested that an agency would have to grant a waiver from a statutory local content requirement, noting that "any expectations that the Investor had with respect to the relevancy or applicability of the case law it cited were not created by any misleading representations made by authorized officials of the U.S. Federal Government but rather, it appears probable, by legal advice received by the Investor from private U.S. counsel."

80 *Waste Management v. Mexico* (supra note 27), par. 98. Similarly *CME Czech Republic B.V. v. The Czech Republic*, UNCITRAL, Partial Award of Sept. 13, 2001, par. 611 (reasoning that the respondent "breached its obligation of fair and equitable treatment by eviscerations of the arrangements in reliance upon which the foreign investor was induced to invest").

81 In *International Thunderbird v. Mexico* (supra note 78) the investor wanted to set up a gaming business in Mexico and sought a statement of the competent agency as to whether its gaming machines were in conformity with domestic Mexican law that prohibited gambling and luck-related gaming. The Tribunal did, however, not consider the opinion given by the administrative agency as sufficiently specific so as to form the basis of legitimate expectations. See also *Metalclad v. Mexico* (supra note 54), par. 85 et sqq., on the violation of fair and equitable treatment pursuant to the (incorrect) statement of a government agency that the permits necessary to start building a waste landfill had been obtained.

82 See *GAMI v. Mexico* (supra note 69), par. 100.

dispute in *CMS v. Argentina*, where the regulatory framework the foreign investor relied upon when making his investment decision was permanently and fundamentally altered at a later stage.[83]

The concept entails, however, the danger that domestic legal orders and the actions of host states are exclusively measured against the expectations of foreign investors. Although the legitimacy of the investor's expectations already limits the scope of the concept,[84] it should not be handled as an inflexible and absolute yardstick. Instead, tribunals should allow for a certain flexibility for host states to react, for example but not exclusively, to emergency situations. Accordingly, the Tribunal in *Eureko v. Poland* suggested that the breach of basic expectations was not a violation of fair and equitable treatment if good reasons existed why the expectations of the investor could not be met.[85] Similarly, the tribunal in *Saluka v. Czech Republic* specifically warned of the danger of taking the idea of the investor's expectation too literally since this would "impose upon host States' [sic] obligations which would be inappropriate and unrealistic".[86] Instead, the Tribunal set out to balance the legitimate expectations and the host state's interests within a broader proportionality test. It reasoned:

> "No investor may reasonably expect that the circumstances prevailing at the time the investment is made remain totally unchanged. In order to determine whether frustration of the foreign investor's expectations was justified and reasonable, the host State's legitimate right subsequently to regulate domestic matters in the public interest must be taken into consideration as well. […]
>
> The determination of a breach of Article 3.1 by the Czech Republic therefore requires a weighing of the Claimant's legitimate and reasonable expectations on the one hand and the Respondent's legitimate regulatory interests on the other.
>
> A foreign investor protected by the Treaty may in any case properly expect that the Czech Republic implements its policies *bona fide* by conduct that is, as far as it affects the investors' investment, reasonably justifiable by public policies and that such conduct does not manifestly violate the requirements of consistency, transparency, even-handedness and nondiscrimination. In particular, any differential treatment of a foreign investor must not be based on unreasonable distinctions and demands, and must be justified by showing that it bears a reasonable relationship to

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83 See specifically on the concept of legitimate expectations in the context of this case Costamagna, *Investors' Rights and State Regulatory Autonomy: the Role of the Legitimate Expectation Principle in the CMS v. Argentina Case*, 3 TDM (issue 2, April 2006) p. 6 et sqq. (available via http://www.transnational-dispute-management.com).

84 See *Saluka v. Czech Republic* (supra note 21), par. 304.

85 See *Eureko v. Poland* (supra note 77), par. 232 et seq.

86 *Saluka v. Czech Republic* (supra note 21), par. 304.

rational policies not motivated by a preference for other investments over the foreign-owned investment."[87]

Overall, the concept of legitimate expectations therefore offers sufficient flexibility to reconcile the interests of foreign investors and host states. The aim of achieving a balance between the protection of confidence or legitimate expectation and the public interest can also be mirrored in the concept of protection of confidence under domestic legal systems.[88]

4. Administrative Due Process and Denial of Justice

Several cases interpreted fair and equitable treatment so as to include the concept of due process. Due process, in this context, mainly comes in two forms: administrative and judicial due process.[89] It is thus closely connected to the proper administration of civil and criminal justice.[90] Recently, both an explicit reference to due process and the concept of denial of justice as part of fair and equitable treatment has been included in the treaty practice of the United States. Art. 10.5(2)(a) of the The Dominican Republic – Central America – United States Free Trade Agreement, for instance, stipulates that

> "fair and equitable treatment includes the obligation not to deny justice in criminal, civil, or administrative adjudicatory proceedings in accordance with the principle of due process embodied in the principal legal systems of the world".[91]

Even absent this explicit reference, investment tribunals have interpreted fair and equitable treatment in this way. The tribunal in *Waste Management v. Mexico*, for instance, defined a violation of fair and equitable treatment as "involv[ing] a lack of due process leading to an outcome which offends judicial propriety – as might be the case with a manifest failure of natural justice in judicial proceedings or a complete lack of transparency and candour in an administrative process."[92]

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87 *Saluka v. Czech Republic* (supra note 21), par. 305 et sqq.

88 See for example on the jurisprudence of the German Constitutional Court Schulze-Fielitz (supra note 39), Art. 20 par. 139 et sqq.

89 The national legislator, so far, has not been subjected to any due process notions in investment arbitration. This could, however, be conceivable in the context of legislative expropriations since most BITs explicitly require expropriations to grant affected investors due process. See Dolzer/Stevens (supra note 22), p. 106 et seq. (1995).

90 See comprehensibly on the closely related concept of denial of justice in international law Paulsson, *Denial of Justice in International Law* (2005).

91 *The Dominican Republic – Central America – United States Free Trade Agreement*, signed Aug. 5, 2004, available at http://www.ustr.gov/assets/Trade_Agreements/Bilateral/CAFTA/CAFTA-DR_Final_Texts/asset_upload_file328_4718.pdf. Similar provisions can be found in a number of other recently concluded and currently negotiated free trade agreement of the U.S., see Kantor (supra note 16).

92 *Waste Management v. Mexico* (supra note 27), par. 98.

Similarly, for the tribunal in *S.D. Myers v. Canada* fair and equitable treatment, among other elements, included "the international law requirements of due process".[93]

The main thrust of the due process requirement in investment treaty arbitration is to establish procedural rights for investors in administrative proceedings. This was emphasized by the Tribunal in *International Thunderbird Gaming v. Mexico* that held that the proceedings of a government agency "should be tested against the standards of due process and procedural fairness applicable to administrative officials".[94] Fair and equitable treatment is, however, equally relevant for the discharge of judicial proceedings.[95] In this context the standard can be violated "if Claimants were denied access to the courts […] or if the Claimants were treated unfairly in those courts (denial of procedural justice) or if the judgment of those courts were substantively unfair (denial of substantive justice)".[96]

5. Protection against Arbitrariness and Discrimination

The protection of foreign investors against arbitrary and discriminatory treatment also plays a major role in the operation of fair and equitable treatment. While sometimes international investment treaties contain a specific provision prohibiting such treatment, arbitral tribunals also ground this aspect in free-standing guarantees of fair and equitable treatment. The connection between arbitrariness and the concept of the rule of law has been explicitly drawn by the decision of the International Court of Justice in the *ELSI Case*. Considering whether the requisition by the Mayor of Palermo of a foreign-owned factory in order to prevent its closure and the layoff of around 1000 workers, the Court observed that

> "[a]rbitrariness is not so much something opposed to a rule of law, as something opposed to the rule of law. This idea was expressed by the Court in the *Asylum* case, when it spoke of 'arbitrary action' being 'substituted for the rule of law'. It is wilful disregard of due process of law, an act which shocks, or at least surprises, a sense of juridical propriety."[97]

Although the case arose under the Friendship, Commerce and Navigation Treaty between the U.S. and Italy, the decision has been widely accepted as being relevant to the interpretation of fair and equitable treatment in international investment treaties.[98] The reason for this may be that

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93 *S.D. Myers v. Canada* (supra note 26), par. 134.

94 *International Thunderbird v. Mexico* (supra note 78), par. 200.

95 See *Compañía de Aguas del Aconquija, S.A. & Compagnie Générale des Eaux (Vivendi) v. Argentina*, ICSID Case No. ARB/97/3, Award of Nov. 21, 2000, par. 80; *Loewen Group, Inc. and Raymond L. Loewen v. United States*, ICSID Case No. ARB(AF)/98/3, Final Award of June 26, 2003, par. 132; *Waste Management v. Mexico* (supra note 27), par. 132.

96 *Vivendi v. Argentina* (supra note 95), par. 80.

97 *ELSI Case* (supra note 29), par. 128 (internal citations omitted).

98 See for example *Alex Genin v. Estonia* (supra note 15), par. 371; *Waste Management v. Mexico* (supra note 27), par. 98; *Noble Ventures v. Romania* (supra note 23), par. 176.

arbitrary conduct can essentially be regarded as a qualified violation of the requirement to act in accordance with domestic law. Arbitrary conduct therefore can be seen as a sufficient but not as a necessary requirement for the violation of fair and equitable treatment. It can also be linked to the requirement under fair and equitable treatment to act in good faith.[99]

The nexus between fair and equitable treatment and the prohibition of discriminatory treatment has been emphasized in the award in *Loewen v. United States*. Here, the Tribunal stated that fair and equitable treatment is violated by "[a] decision which is in breach of municipal law and is discriminatory against the foreign litigant amounts to manifest injustice".[100] Similarly, the Tribunal in *Waste Management v. Mexico* elaborated that "fair and equitable treatment is infringed by conduct attributable to the State and harmful to the claimant if the conduct is arbitrary, grossly unfair, unjust or idiosyncratic, is discriminatory and exposes the claimant to sectional or racial prejudice".[101]

Other tribunals suggest drawing a clearer distinction between fair and equitable treatment and the prohibition of discriminatory conduct. They emphasize that "[c]ustomary international law does not […] require that a state treat all aliens (and alien property) equally, or that it treats aliens as favourable as nationals".[102] They only consider a violation of fair and equitable treatment if the investor was "specifically targeted" or if the differential treatment amounted to bad faith.[103]

6. Transparency

A few cases have based a violation of fair and equitable treatment based on a lack of transparency. The Tribunal in *Metalclad Corporation v. Mexico,* for instance, found that the respondent breached Art. 1105 NAFTA because "Mexico failed to ensure a transparent and predictable framework for Metalclad's business planning and investment".[104] In a similar manner,

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99 See *Waste Management v. Mexico* (supra note 27), par. 138: "A basic obligation of the State under Article 1105(1) is to act in good faith and form, and not deliberately to set out to destroy or frustrate the investment by improper means"; *Alex Genin v. Estonia* (supra note 15), par. 367: "Acts that would violate [F&ET] would include acts showing a wilful neglect of duty, an insufficiency of action falling far below international standards, or even subjective bad faith." See also *Tecmed v. Mexico* (supra note 29), par. 154.

100 *Loewen v. United States* (supra note 95), par. 135.

101 *Waste Management v. Mexico* (supra note 27), par. 98; similarly *Eureko v. Poland* (supra note 77), par. 233, finding that the State acted not "for purely arbitrary reasons linked to the interplay of Polish politics and nationalistic reasons of a discriminatory character" and therefore did not breach fair and equitable treatment". *S.D. Myers v. Canada* (supra note 26), par. 266, also draws a parallel between national treatment and the fair and equitable treatment standard when stating that "the Tribunal does not rule out the possibility that there could be circumstances in which a denial of the national treatment provisions of the NAFTA would not necessarily offend the minimum standard provisions, a majority of the Tribunal determines that on the facts of this particular case the breach of Article 1102 essentially establishes a breach of Article 1105 as well."

102 *Alex Genin v. Estonia* (supra note 15), par. 386; similarly *Methanex Corporation v. United States of America*, UNCITRAL, Final Award of Aug. 3, 2005, Part IV - Chapter C par. 25.

103 *Alex Genin v. Estonia* (supra note 15), par. 369 and 371.

104 *Metalclad v. Mexico* (supra note 54), par. 99 (emphasis added).

the Tribunal in *Tecmed v. Mexico* connected the element of legitimate expectations to the requirement of transparency by stating:

> "The foreign investor expects the host State to act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor, so that it may know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives, to be able to plan its investment and comply with such regulations. "[105]

Especially, the decision in *Metalclad v. Mexico* has received major critique for interpreting fair and equitable treatment as including a transparency requirement and has been set aside by the Supreme Court of Columbia exercising jurisdiction under the British Columbia International Arbitration Act for this reason.[106] Yet, the Court seems to have over-interpreted the scope of the transparency requirement the Tribunal deduced from fair and equitable treatment.[107] Indeed, if transparency is considered to mean "that all relevant legal requirements for the purpose of initiating, completing and successfully operating investments […] should be capable of being readily known to all affected investors" and requires the host state "to ensure that the correct position is promptly determined and clearly stated so that investors can proceed with all appropriate expedition in the confident belief that they are acting in accordance with all relevant laws",[108] such an onerous standard risks to "overstretch the position and function of administrative agencies by developing them into consultative units and insurers for the implementation of foreign investment projects".[109]

Yet, a more restrictive reading of the transparency requirement seems equally possible and more closely related to the concept of the rule of law. In the *Tecmed*-case, for example, transparency mainly referred to procedural aspects of administrative law, such as the requirement to give sufficient reasons[110] and the obligation to act in a comprehensible and predictable way.[111]

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105 *Tecmed v. Mexico* (supra note 29), par. 154; similarly *Maffezini v. Spain* (supra note 62), par. 83.

106 See Supreme Court of British Columbia, *The United Mexican States v. Metalclad Corporation*, 2001 BCSC 644, available via http://www.investmentclaims.com.

107 In addition, it is questionable whether the domestic courts acted in conformity with the provisions of NAFTA when entertaining a suit in view of setting aside the award. See on this Brower, *Investor-State Disputes Under NAFTA: The Empire Strikes Back*, 40 Colum. J. Transnat'l L. 43 (2001).

108 *Metalclad v. Mexico* (supra note 54), par. 76 (for both citations).

109 Schill, *Revisiting a Landmark: Indirect Expropriation and Fair and Equitable Treatment in the ICSID Case* Tecmed, 3 TDM (issue 2, April 2006) p. 15 (available via http://www.transnational-dispute-management.com); for the original German version of this article see Schill, *Völkerrechtlicher Investitions- und Eigentumsschutz in der ICSID-Entscheidung TECMED*, in: 51 Recht der Internationalen Wirtschaft 330 (2005).

110 See *Tecmed v. Mexico* (supra note 29), par. 123: "administrative decisions must be duly grounded in order to have, among other things, the transparency required so that persons that disagree with such decisions may challenge them through all the available legal remedies." Similarly, *Tecmed v. Mexico*, par. 164.

111 See *Tecmed v. Mexico* (supra note 29), par. 160: "The incidental statements as to the Landfill's relocation in the correspondence exchanged between INE and Cytrar or Tecmed […] cannot be considered to be a clear and unequivocal expression of the will of the Mexican authorities to change their position as to the extension of the

Essentially, these statements only reiterate more general requirement of the rule of law that relate to the procedural position of foreign investors in administrative proceedings. Transparency does therefore not necessarily have to be viewed as an additional substantive requirement, but rather as an instrument of procedurally resolving uncertainty in the domestic law and closely interacts with the burden of proof. As a matter of procedural fairness uncertainties of domestic law should not be imposed to the detriment of the foreign investor who is less accustomed to the general legal and political culture of the host state. In that sense it is fully compatible with a procedural understanding of the rule of law and does not impose obligations upon host states to counsel foreign investors or provide them with comprehensive legal advice.

7. Reasonableness and Proportionality

Finally, arbitral tribunals often link fair and equitable treatment to the concept of reasonableness and proportionality. Such criteria also play an important role as part of the rule of law in many domestic legal systems, the law of the European Union and the jurisprudence of the European Court of Human Rights.[112] Its function, however, mainly consists in controlling the extent to which interferences of host states with foreign investments are permitted. In this light, the Tribunal in *Pope & Talbot v. Canada* repeatedly referred to the reasonableness of the conduct of an administrative agency in order to decline a violation of fair and equitable treatment.[113] The mitigating role of the principle of proportionality has also been applied in the decision in *Saluka v. Czech Republic* as a way to balance the host state's interest in upholding the stability of its banking sector and the expectations of the foreign investor.[114]

Permit so long as Cytrar's business was not relocated, nor can it be considered an explicit, transparent and clear warning addressed to Cytrar from the Mexican authorities that rejected conditioning the revocation of the Permit to the relocation of Cytrar's operations at the Landfill to another place".

112 See for example Schulze-Fielitz (supra note 39), Art. 20 par. 167 et sqq. on German constitutional law where the proportionality principle arguably finds its origins in modern positive constitutional law. See also Ellis (ed.), *The Principle of Proportionality in the Laws of Europe* (1999); on proportionality as a principle in EU/EC law Emiliou, *The Principle of Proportionality in European Law*, p. 23 et sqq. (1996); Nolte, *General Principles of German and European Administrative Law - A Comparison in Historic Perspective*, 191 Mod. L. Rev. 191 (1994); see also Gunn, *Deconstructing Proportionality in Limitations Analysis*, 19 Emory Int'l L. Rev. 465 (2005). Proportionality is also a guiding principle in the interpretation of the European Convention on Human Rights, see van Dijk/van Hoof, *Theory and Practice of the European Convention on Human Rights*, p. 80 et sqq. (1998).

Critical however concerning the scope of the proportionality requirement in U.S. constitutional law in particular concerning criminal law in the context of the Eighth Amendment see Ristroph, *Proportionality as a Principle of Limited Government*, 55 Duke L. J. 263 (2005) with further references; see also on the hesitance in U.S. constitutional law to accept proportionality as a general principle Jackson, *Ambivalent Resistance and Comparative Constitutionalism: Opening up the Conversation on "Proportionality", Rights And Federalism*, 1 U. Pa. J. Const. L. 583 (1999).

113 See *Pope & Talbot v. Canada* (supra note 68), par. 123, 125, 128, 155; see also *MTD v. Chile* (supra note 20), par. 109 with a reference to an expert opinion by *Schwebel*.

114 See above all *Saluka v. Czech Republic* (supra note 21), par. 304 et sqq.

Another award that used proportionality as concept restricting generally permissibly interferences with foreign investments is the decision in *Tecmed v. Mexico*. Here, the Tribunal incorporated a proportionality test as a method to distinguish between a compensable indirect expropriation and a non-compensable regulation.[115] In the Tribunal's reasoning an indirect expropriation occurs whenever a restriction of the right to property is disproportional:

> "[T]he Arbitral Tribunal will consider, in order to determine if they are to be characterized as expropriatory, whether such actions or measures are proportional to the public interest presumably protected thereby and to the protection legally granted to investments, taking into account that the significance of such impact has a key role upon deciding the proportionality. […] There must be a reasonable relationship of proportionality between the charge or weight imposed to the foreign investor and the aim sought to be realized by any expropriatory measure."[116]

Although integrating proportionality into the principle of fair and equitable treatment allows to a certain extent for a substantive control of host state conduct, the proportionality requirement also clarifies that fair and equitable treatment is not an inflexible standard, but allows for the balancing of the interests of host states and foreign investors. As long as sufficient leeway is given for the implementation of domestic policies and as long as tribunals refrain from using it in order to establish a comprehensive standard of review, proportionality constitutes a concept that helps to counter fears about the dominance of investors' rights over the interests of host states. Although the concept of proportionality as part of fair and equitable treatment is still in its infancy, it helps to reconcile the interests of foreign investors with the necessary implementation of regulatory policies by host states.

B. Contextualization of Fair and Equitable Treatment in the Separation of Powers Framework

Although the elements arbitral tribunals have developed in order to concretize the principle of fair and equitable treatment are of a fairly general nature, they can be further concretized in regard of the discharge of public power by the domestic administration, in domestic legal proceedings and national legislation. Fair and equitable treatment, thus, develops into increasingly specific requirements that national legal systems have to incorporate in order to comply with international investment treaties. Fair and equitable treatment therefore assumes a function that is comparable to domestic constitutional law, however with two modifications: it only constitutes a special regime for foreign investors and, only entitling to damages in case the host state violates its treaty obligations, does not assume normative supremacy.

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115 Schill (supra note 109), 3 TDM (issue 2, April 2006) p. 9 et sqq.

116 *Tecmed v. Mexico* (supra note 29), par. 122.

1. Fair and Equitable Treatment and Domestic Administrative Law

National administrative law is particularly prone to the influence of fair and equitable treatment as foreign investors are affected by administrative proceedings at various stages of an investment project, reaching from the application for and issuance of operating licenses to the general regulatory control and supervision of their undertaking. In this context, several sub-elements of the principle establish rule of law components that serve as a yardstick for domestic administrative law. In this context, fair and equitable treatment becomes a *Leitmotiv* in structuring the relationship between investors and national administrations.[117] The rule of law elements that mainly influence domestic administrative law are the principle of legality, the protection of confidence and the requirement of due process. These elements influence, for example, the structure and process of administrative decision-making, account for procedural rights of foreign investors and may limit the exercise of administrative discretion.

a) Administrative Procedure

With respect to administrative procedure, in particular concerning the granting, renunciation or renewal of operating licenses, fair and equitable treatment requires domestic administrations to grant foreign investors a fair hearing, conduct proceedings in a comprehensible way and give reasons for the decision. The right to a fair hearing and the right to participation in administrative proceedings played a role in the NAFTA case *Metalclad v. Mexico* where the Tribunal found a breach of fair and equitable treatment because the investor was not properly involved. According to the Tribunal the investor should have been given the chance to participate in a meeting of a local town council that discussed whether a construction permit was to be given for the investor's waste landfill.[118] Similarly, the Tribunal in *Tecmed v. Mexico* emphasized the right to a fair hearing as part of fair and equitable treatment in the context of an administrative proceeding that concerned the non-prolongation of an operating license for a waste landfill. It also stated that the standard required the national administration to take decisions about the requests of a foreign investor.[119]

Fair and equitable treatment further requires the domestic administration to give reasons for their decisions and base them on sufficient factual evidence. The purpose of this requirement is to rationalize the decision-making process and to secure that decisions are taken in accordance with the legal requirements contained in domestic law. Against this backdrop, the Tribunal in *Metalclad v. Mexico* determined that Mexico had breached the fair and equitable treatment standard because the Town Council's decision to deny the construction permit was not grounded in considerations

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117 Schill (supra note 109), 3 TDM (issue 2, April 2006) p. 13 et sqq.

118 The Tribunal particularly pointed out that "the permit was denied at a meeting of the Municipal Town Council of which Metalclad received no notice, to which it received no invitation, and at which it was given no opportunity to appear", *Metalclad v. Mexico* (supra note 54), par. 91.

119 See *Tecmed v. Mexico* (supra note 29), par. 161 et sqq. More specifically on the elements of a fair hearing required under fair and equitable treatment Weiler, *NAFTA Article 1105 and the Principles of International Economic Law*, 42 Colum. J. Transnat'l L. 35, 79 et seq. (2003).

concerning "construction aspects or flaws of the physical facility"[120] but was mainly motivated by the opposition of the local population against the landfill. In the Tribunal's view, the decision was therefore not supported by evidence pertaining to legitimate criteria under the municipal construction law. The requirement to supply sufficient evidence also results in a duty to conduct fact-finding and verifying evidence before a final decision is taken. Furthermore, the requirement to give reasons shall facilitate the legal review of an administrative decision.[121] Overall, fair and equitable treatment therefore requires that domestic administrative proceedings conform to standards that are derived from a process-oriented understanding of the rule of law.[122]

b) Exercise of Administrative Discretion

Fair and equitable treatment can also restrict or channel the exercise of the administration's discretionary power. The standard requires administrative agencies to sufficiently take into account the effect of their decisions on foreign investors. In addition, the element of consistency and the concept of legitimate expectations play an important role regarding the exercise of administrative discretion.

The case in *Middle East Cement Shipping and Handling Co S.A. v. Egypt*[123] involved the seizure and auctioning of the claimant's vessel in order to recover debts the investor had incurred in relation to a state entity. Interestingly, the issue focused on the question whether the procedural implementation of the auction was valid, in particular whether sufficient notice of the seizure was given.[124] Arguably in conformity with Egyptian law, the notice was given by attaching a copy of a distraint report to the vessel, because the claimant could not be found onboard the ship. The Tribunal, however, considered that the authority had wrongly exercised its discretion by using this *in absentia* notification instead of notifying the claimant directly at his local address. Relying on the principle of fair and equitable treatment in interpreting the due process requirement in the expropriation provision of the Greek-Egyptian BIT, the Tribunal reasoned that

> "a matter as important as the seizure and auctioning of a ship of the Claimant should have been notified by a direct communication […] irrespective of whether there was a legal duty or practice to do so by registered mail with return receipt".[125]

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120 *Metalclad v. Mexico* (supra note 54), par. 93.

121 See *Tecmed v. Mexico* (supra note 29), par. 123.

122 See for parallel developments of transnational administrative law in the context of administrative proceedings in the EU/EC and similar developments under WTO law, della Cananea, *Beyond the State: the Europeanization and Globalization of Procedural Administrative Law*, 9 Eur. Publ. L. 563 (2003).

123 *Middle East Cement Shipping and Handling Co S.A. v. Arab Republic of Egypt*, ICSID Case No. ARB/99/6, Award of April 12, 2002.

124 The issue turned around the question whether the seizure yielded the requirement of due process in the provision protecting against direct and indirect expropriations in the Egyptian-Greek BIT and the principle of fair and equitable treatment.

125 *Middle East Cement Shipping v. Egypt* (supra note 123), par. 143.

The exercise of administrative discretion can also be limited by the principle of consistency and the concept of legitimate expectations. Consistency requires that administrative agencies exercise their discretion according to uniform standards and do not deviate from standard procedures or the usual assessment of comparable circumstances. Consistency may not only influence administrative decision-making with respect to the granting of licenses,[126] but can also restrict the intervention by administrative agencies in order to enforce domestic law. If, for example, the domestic administration has consistently tolerated a specific unlawful conduct, fair and equitable treatment may prevent them from intervening against a foreign investor who engaged in the same conduct. Similarly, legitimate expectations of the investor can reduce the administration's discretionary power. Acting contrary to representations made by government officials, for instance, constitutes a breach of fair and equitable treatment.[127]

2. Fair and Equitable Treatment and Domestic Judicial Procedures

The rule of law elements derived from fair and equitable treatment also influence the institutional structure of the host state's judiciary and the procedural law they apply. Fair and equitable treatment requires that host states provide a fair and efficient system of justice,[128] comprising effective judicial dispute settlement procedures for the review of administrative acts[129] and dispute settlement between private parties.[130] In *Mondev v. United States* the Tribunal, for example, entertained the possibility that "the conferral of a general immunity from suit for conduct of a public authority affecting a NAFTA investment could amount to a breach of Article 1105(1) of NAFTA".[131] In *Azinian v. Mexico* the Tribunal pointed out that "a denial of justice could be pleaded if the relevant courts refused to entertain a suit, if they subject it to undue delay, or if they administer justice in a seriously inadequate way."[132] Accordingly, fair and equitable treatment grants a right to access to a court for foreign investors.

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126 See *MTD v. Chile* (supra note 20), par. 107 et sqq.

127 See *International Thunderbird v. Mexico* (supra note 78), par. 137 et sqq.; *Metalclad v. Mexico* (supra note 54), par. 85 et sqq.

128 *Loewen v. United States* (supra note 95), par. 153 with further references.

129 Compare *Waste Management v. Mexico* (supra note 27), par. 116: "the availability of local remedies to an investor faced with contractual braches is nonetheless relevant to the question whether a standard such as article 1105(1) have [sic] been complied with by the State."

130 *Loewen v. United States* (supra note 95), par. 129: "customary law is concerned with the denial of justice in litigation between private parties"; *ibid.*, par. 123: "the responsibility of the State under international law and, consequently, of the courts of a State, to provide a fair trial of a case to which a foreign investor is a party. It is the responsibility of the courts of a State to ensure that litigation is free from discrimination against a foreign litigant and that the foreign litigant should not become the victim of sectional or local prejudice."

131 See *Mondev v. United States* (supra note 12), par. 151, concluding, however, that the immunity granted to a municipal authority in the case at hand was not a violation of fair and equitable treatment.

132 *Robert Azinian, Kenneth Davitian, & Ellen Baca v. The United Mexican States*, ICSID Case No. ARB (AF)/97/2, Final Award of Nov. 1, 1999, par. 102.

Similarly, the procedure applied by domestic courts has to conform to the rule of law requirements stemming from fair and equitable treatment. This requires courts to entertain suits in a timely fashion, to give a fair hearing to the foreign investor on all essential questions, not to base a decision on unexpected legal grounds and give reasons for the decisions reached.[133] In essence, concerning the judicial proceedings the obligations stemming from fair and equitable treatment will be similar to the obligations arising under human rights instruments, such as Art. 6 of the European Convention on Human Rights.[134]

3. Fair and Equitable Treatment and Domestic Legislation

Finally, fair and equitable treatment also affects the way national legislators deal with foreign investors.[135] Although domestic legislation is only rarely subject to the assessment of investment tribunals, mainly due to the fact that it often requires specific implementation by administrative or judicial decisions and does not affect foreign investors directly,[136] fair and equitable treatment can result in significant restrictions of the domestic legislator, mainly based on the rule of law element of legitimate expectations or protection of confidence.

So far the apparently only case that concerned the impact of fair and equitable treatment on the domestic legislator is the dispute in *CMS v. Argentina*. Although the Tribunal emphasized that it "does not have jurisdiction over measures of general economic policy […] and cannot pass judgment on whether they are right or wrong […] it has jurisdiction to examine whether specific measures affecting the Claimant's investment or measures of general economic policy having a direct bearing on such investment have been adopted in violation of legally binding commitments made to the investor in treaties, legislation or contracts."[137]

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133 See *Azinian v. Mexico* (supra footnote 132), par. 102. To a lesser extent fair and equitable treatment may also require the outcome of a legal decision to conform to substantive rule of law standards or, as expressed by the tribunal in *Vivendi v. Argentina* (supra note 95), par. 80: "substantive justice".

134 European Convention for the Protection of Human Rights and Fundamental Freedoms and its protocols, 4 Nov. 1950, 213 U.N.T.S. 222. For this analogy see *Mondev v. United States* (supra note 12), par. 144. Compare also Art. 19(4) of the German Basic Law that provides for a guarantee to have judicial recourse against acts of public authority.

135 Under general international law it is established that the internal law of a state cannot be invoked as a justification for its failure to perform a treaty, see Art. 27 of the Vienna Convention on the Law of Treaties. As a consequence, the breach of an international obligation by the domestic legislator entails state responsibility since acts of the legislator can constitute internationally wrongful acts. Art. 4(1) of the ILC Draft Articles on State Responsibility. See on further authority see International Law Commission, *Commentary on the Draft Articles on State Responsibility*, Art. 4 par. 4 (2001), available at http://untreaty.un.org/ilc/texts/instruments/english/commentaries/9_6_2001.pdf.

136 Compare in this context on the question of the self-executing nature of expropriatory legislation *Jahangir Mohtadi, et al.* and *The Government of the Islamic Republic of Iran*, Award No. 573-271-3 (2 Dec. 1996), 32 Iran-U.S. C.T.R. 124, 140 et sqq.; *Reza Said Malek* and *The Government of the Islamic Republic of Iran*, Final Award No. 534-193-3 (11 Aug. 1992), 28 Iran-U.S. C.T.R. 246, 266 et sqq.

137 *CMS v. Argentina* (supra note 50), Decision on Jurisdiction, par. 33.

On the merits, the Tribunal in *CMS v. Argentina* specified that transparency, consistency in the governmental decision making process, orderly process and predictability constituted the core elements of fair and equitable treatment also with respect to national legislation.[138] Measures that entirely convert the existing legal framework, such as the fundamental change in the U.S. dollar-based tariff calculation that was relied upon by the investor when making his initial investment decision, were found to breach fair and equitable treatment. Arguably, the key factor in this context was the permanent abrogation of the existing tariff system that completely waived the central promises made vis-à-vis the investor and breached his legitimate expectations.[139]

Yet, the protection of confidence should not be interpreted as an absolute guarantee. Rather, as the Tribunal in *Saluka v. Czech Republic* rightly pointed out, "[n]o investor may reasonably expect that the circumstances prevailing at the time the investment is made remain totally unchanged".[140] Although the stability of the legal framework is an essential factor for the investment decision of foreign investors, one cannot presume that host states denounced their right to legislate and change domestic legal rules by entering into international investment treaties. Concerning the concept of legitimate expectations, it therefore seems appropriate to draw a distinction between situations where a host state has incited specific confidence in the stability of certain regulations and situations where a foreign investor merely relied on the regulatory framework of the host state in a more general way.

In the first case, the concept of legitimate expectations will find its genuine application. Not only are expectations in this context directly attributable to a host state, but moreover did the host state know about the specific weight the foreign investor placed on the regulatory infrastructure in making its investment decision. Yet, absent specific contractual commitments for instance, legitimate expectations will not operate so as to absolutely deny any changes in the regulatory framework. Based on the principle of proportionality, in particular emergency situations may justify even severe interferences.[141]

In the second case, where a foreign investor merely relies on the general legal framework without any specific commitments or intention on behalf of the host state to attract foreign investors, the concept of legitimate expectations may only have a more marginal scope of application. It will mostly come into play with respect to legislation with a retroactive affect.[142] Apart from that, it is difficult to imagine cases of legislative regulatory change that violate fair and equitable treatment but do not at the same constitute measures with an expropriatory effect.

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138 *CMS v. Argentina* (supra note 15), par. 276 et sqq. with further references.

139 See also Costamagna (supra note 83), 3 TDM (issue 2, April 2006), p. 6 et sqq.

140 *Saluka v. Czech Republic* (supra note 21), par. 305.

141 Compare Christie, *What Constitutes a Taking of Property Under International Law?*, 38 Brit. Yb. Int'l L. 307, 331 (1962) (noting that in the context of expropriation the purpose of a host state's conduct may justify "even severe, although by no means complete, restrictions on the use of property").

142 See for example Schulze-Fielitz (supra note 39), Art. 20 par. 139 et sqq.

C. Methodological Implications of the Rule of Law Approach

Understanding fair and equitable treatment as an embodiment of the rule of law does not only clarify its normative content, it also suggests a specific methodology investment tribunals should follow in concretizing the standard and in solving conflicts between the sometimes competing interests of host states and foreign investors. Instead of primarily relying on prior arbitral decisions, an approach that is little helpful in particular when disputes concern novel circumstances, or positing the content of fair and equitable treatment in an abstract way without sufficient justification, tribunals should use a comparative method that draws on domestic and international law regarding the concept of the rule of law. These bodies include the understanding of the rule of law and its implications in domestic legal systems, and the jurisprudence developed by other international tribunals, for example in the human rights or international trade context.

1. Comparative Analysis of Domestic Legal Systems

The first approach relies on a comparative approach to rule of law standards contained in the major legal systems that adhere to a liberal tradition. This approach essentially relies on the attempt to extract general principles of law in order to concretize fair and equitable treatment. This approach has also been proposed in order to concretize the concept of indirect expropriation under international law and its distinction from non-compensable regulation.[143] With respect to the concept of the rule of law, such an approach can be made equally fruitful concerning the interpretation of fair and equitable treatment. Arbitral tribunals should therefore engage in a comparative analysis of the major domestic legal systems in order to grasp common features those legal systems establish for the exercise of public power.

Such a comparative analysis may influence the interpretation of fair and equitable treatment mainly in two respects. First, it may enable investment tribunals to positively deduce institutional and procedural requirements from the domestic rule of law standards for a context-specific interpretation of fair and equitable treatment. A comparative analysis of domestic legal systems and their understanding of the rule of law may, for example, be used to justify the standards administrative proceedings affecting foreign investors have to live up to.[144] Secondly, a comparative analysis of the implications of the rule of law under domestic law may be used to justify the conduct of a state vis-à-vis a foreign investor under the fair and equitable treatment standard. If similar conduct, for instance the repudiation of an investor-state contract in an

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143 Dolzer, *Eigentum, Enteignung und Entschädigung im geltenden Völkerrecht*, p. 213 et sqq. (1985). Dolzer, *Indirect Expropriation of Alien Property*, 1 ICSID Rev 41 (1986). Similarly Salacuse/Sullivan, *Do BITs Really Work? An Evaluation of Bilateral Investment Treaties and Their Grand Bargain*, 46 Harv. Int'l L. J. 67, 115 (2005).

144 See also della Cananea (supra note 122), 9 Eur. Publ. L. 563, 575 (2003) (explaining that the WTO Appellate Body in the Shrimps Case has "subsumed from national legal orders some general or 'global' principles of administrative law" in order to impose procedural rule of law elements on the exercise of public power of the WTO Member States).

emergency situation, is generally accepted by domestic legal systems as being in conformity with their understanding of the (national) rule of law, investment tribunals can transpose such findings to the level of international investment treaties as an expression of a general principle of law.

2. Comparative Analysis of International Legal Regimes

The second methodological approach relies on a cross-regime comparison with other international law regimes that incorporate rule of law standards. A particularly promising field for such an approach is the comparative evaluation of the jurisprudence developed by international courts in the human rights context that address specific elements of the rule of law. The primary example in this context is the jurisprudence of the European Court of Human Rights (ECtHR) concerning Art. 6 of the European Convention on Human Rights (ECHR). This provision can be viewed as an expression of a more general standard of an institutional and procedural understanding of the rule of law.[145] The rich jurisprudence of the ECtHR could thus be used to further concretize fair and equitable treatment, for example with respect to the timely administration of justice or the right to a fair trial.[146] Similarly, comparative recourse could be had to the emerging principles of European administrative law[147] or the jurisprudence of the WTO Appellate Body in order to further develop the rule of law requirements with respect to the exercise of public power.[148] The comparative analysis of rule of law understandings under both domestic legal systems and other international law regimes should be able to give examples for the effect of the rule of law and the scope of restrictions it imposes on states and thus further clarify the content of fair and equitable treatment in international investment law. Yet, it will, always be necessary to keep in mind the specific context of international investment treaties which aim at protecting and promoting foreign investment between the contracting state parties.

IV. A Normative Justification of the Rule of Law Approach

Explaining the various context-specific implementations and sub-elements derived from fair and equitable treatment as an embodiment of the rule of law can also be normatively grounded in international investment treaties by linking this understanding to the intentions of the contracting

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145 This approach has occasionally already played a role in investment arbitration. See *Mondev v. United States* (supra note 12), where parallels were considered between Art. 7 ECHR (freedom from non-retrospective effect of penal legislation) and Art. 1105 NAFTA (par. 138) and between the assessment of granting immunity to a state agency under Art. 1105 NAFTA and Art. 6 ECHR (par. 141 et sqq.). Another example of an investment tribunal that drew a parallel between the jurisprudence of the European Court of Human Rights as well as the Inter-American Court of Human Rights in the context of indirect expropriation is *Tecmed v. Mexico* (supra note 29), par. 166, 122.

146 For an account of the jurisprudence of the European Court of Human Rights concerning Art. 6 ECHR, see van Dijk/van Hoof, *Theory and Practice of the European Convention on Human Rights*, p. 391 et sqq. (1998).

147 See for example Schwarze, *Europäisches Verwaltungsrecht* (2nd ed. 2005).

148 See della Cananea (supra note 122), 9 Eur. Publ. L. 563, 575 (2003).

parties as expressed in the object and purpose of international investment treaties. This teleology can be instrumentalized in equating fair and equitable treatment with the concept of the rule of law as a guiding and restricting principle for the exercise of public power by host states. In particular, institutional economics suggest that the concept of the rule of law contributes to the promotion of foreign investment and, more generally, economic growth and development.

A. The Teleology of International Investment Treaties

As expressed in their preambles, international investment treaties aim not only at protecting but also at promoting foreign investment.[149] Investment flows will, however, depend on the decision of foreign investors to invest in a certain country. One critical factor for this investment decision is the political risk of the host country.[150] Consequently, international investment treaties intend to establish a legal regime that reduces the political risk associated with foreign investment in order to increase investment flows between the contracting parties[151].

The mechanisms for the protection and promotion of foreign investment are, however, not an end in themselves. They are rather closely related to the goals of economic growth and development, in particular in developing countries. This was explicitly mentioned as an objective of the ICSID Convention that recognized "the need for international cooperation for economic development, and the role of private international investment therein".[152] The link between the inflow of foreign investment and economic development is further reinforced by the character of the World Bank as a development institution.[153] The implementation of an investor-state dispute settlement mechanism under the ICSID Convention therefore aimed at reducing the political risk

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149 See Dolzer/Stevens (supra note 22), p. 11 et sqq., 20 et sqq. (1995). See in general on the effects of bilateral investment treaties on actual flows of foreign investment Neumayer/Spess, *Do Bilateral Investment Treaties Increase Foreign Direct Investment to Developing Countries?*, 33 World Development 1567 (2005); Büthe/Milner, *The Politics of Foreign Direct Investment into Developing Countries: Increasing FDI through Policy Commitment via Trade Agreements and Investment Treaties?*, available at http://www.duke.edu/~buthe/downloads/ButheMilner_FDI_v6.pdf; Salacuse/Sullivan (supra note 143), 46 Harv. Int'l L. J. 67 (2005); Tobin/Rose-Ackerman, *Foreign Direct Investment and the Business Environment in Developing Countries: the Impact of Bilateral Investment Treaties*, Yale Law School Center for Law, Economics and Public Policy Research Paper No. 293. (all suggesting, albeit to differing degrees the existence of an empirical link between the existence of BITs, the domestic policy framework and actual investment flows).

150 On the connection between international investment treaties and the reduction of political risk see Rubins/Kinsella (supra note 50), p. 1 et sqq. (2005).

151 See Vandevelde, *The Economics of Bilateral Investment Treaties*, 41 Harv. Int'l L. J. 469, 478 et sqq. (2000). In this line concludes that the "principal contribution [of bilateral investment treaties] to increasing investment is to reduce risk for investors and thereby provide some inducements for those investments that the host state desires" (ibid., at 490).

152 See preamble of the ICSID Convention.

153 Broches, *The Convention on the Settlement of Investment Disputes between States and Nationals of Other States*, 136 Recueil des Cours 331, 342 et seq. (1972-II); Schöbener/Markert, *Das International Centre for Settlement of Investment Disputes (ICSID)*, 105 ZVglRWiss 65, 67 (2006).

connected with investing in a developing country with weaker domestic institutions and a less stable legal and political infrastructure in the interest of growth and development.[154] Accordingly, from a macroeconomic perspective foreign investment is perceived as "a supplement to a necessarily limited volume of public development finance".[155]

B. Institutional Economics and the Role of the Rule of Law

Institutional economics help to explain the function of the rule of law with respect to both objectives of international investment treaties, the promotion of foreign investment and economic growth and development. Institutional economics analyze the relationship between institutions, markets and growth. Institutions, in this context, are "rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction."[156] Institutions are characterized by constraints with a certain permanence and durability which are imposed on actors.[157] They comprise legal rules that impose restrictions on the behavior of individuals as well as legal requirements that concern the exercise of public power. Institutions thus have a double thrust in avoiding private disorder, on the one hand, as well as public dictatorship on the other.[158] They are also essential for the functioning of markets as they "structure incentives in human exchange, whether political, social, or economic".[159] In this sense, the rule of law as a concept of restricting public power can be properly understood as an institution that constitutes one of the bases of market economies.

Concerning the immediate objective of international investment treaties, the concept of the rule of law is important in the context of attracting investment into foreign, particularly developing countries. This becomes clear from an empirical perspective. According to a survey by the World Bank, investors primarily make their decision to invest dependent upon the credibility of states to ensure a predictable and stable legal framework, or – in other words – to effectively implement the rule of law.[160] Conversely, government activity and domestic legal procedures that do not adhere to

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154 See for an overview on the contentious question to what extent foreign investment actually contributes to economic growth Cosbey, *International Investment Agreements and Sustainable Development: Achieving the Millenium Development Goals*, p. 11 et seq. (2005), available at http://www.iisd.org/pdf/2005/investment_iias.pdf.

155 Broches (supra note 153), 136 Recueil des Cours 331, 343 (1972-II).

156 North, *Institutions, Institutional Change, and Economic Performance*, p. 3 (1990). See also North, *Structure and Change in Economic History*, p. 201 et seq. (1981): "a set of rules, compliance procedures, and moral and ethical behavioral norms designed to constrain the behavior of individuals in the interests of maximizing the wealth or utility of principals."

157 See Glaeser/La Porta/Shleifer, *Do Institutions Cause Growth?*, 9 J. Econ. Growth 271, 275 (2004).

158 See for this double thrust in evaluating the rule of law as an economic institution Djankov/Glaeser/La Porta/Lopez-de-Silanes/Shleifer, *The New Comparative Economics*, Working Paper 9608, NBER Working Papers Series, p. 3, available at http://www.nber.org/papers/w9608.

159 North (supra note 156), p. 3 (1990).

160 World Bank, *World Development Report – The State in a Changing World* 5, p. 34 et sqq. (1997).

the concept of the rule of law constitute a critical deterrent for an investment decision in a specific country. Government according to rule of law is therefore a prerequisite for risk-adverse investor for investing in a specific country. This should influence the interpretation of international investment treaties, in particular concerning the principle of fair and equitable treatment.

Yet, the rule of law does not only influence the foreign investor's microeconomic perspective. Instead, institutional economics also suggests a link between the rule of law and the broader objective of international investment treaties, i. e. economic growth and development, because "[e]conomic institutions matter for economic growth because they shape the incentives of key economic actors in society, in particular, they influence investments in physical and human capital and technology, and the organization of production."[161]

The importance of the rule of law in the decision making process of economic actors has been highlighted in economic literature since its earliest days. *Max Weber* was among the first scholars to argue for the interdependence of the emergence of modern forms of growth-creating market-economies in Western civilizations and a modern legal system based on rational and predictable rules.[162] For him the core explanation for economic growth in Europe was the rationality of the legal institutions, including the existence and enforcement of contracts and property rights, which had emerged in the socio-legal discourse in the 18th and 19th century and subsequently paved the way for the development of modern market economies.[163] *Weber* primarily showed that modern law "helps structure the free market system".[164]

Although *Weber* primarily focused on the function of legal institutions to create horizontal order between private individuals by enabling them to use private law institutions for purposes of private ordering, institutions are also critical in the relationship between the state and society. In this context, the rule of law is the primary and, at the same time, most general expression for the predictable exercise of public power vis-à-vis the individual. This second aspect complements the function of the rule of law as an institution that aims at not only avoiding private disorder but also public dictatorship.[165] It is also the aspect that grasps the public law understanding of the concept and its function of limiting the exercise of public power.

This aspect has been described as an important factor for the functioning of market economies and economic growth. Already *Adam Smith* noted that

> "[c]ommerce and manufacturers can seldom flourish long in any state which does not enjoy a regular administration of justice, in which the people do not feel

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161 Acemoglu/Johnson/Robinson, *Institutions as the Fundamental Cause of Economic Growth*, Working Paper 10481, NBER Working Paper Series, p. 2, available at http://www.nber.org/papers/w10481.

162 Weber, *Wirtschaft und Gesellschaft – Grundriss der verstehenden Soziologie* (4th ed. J. Winckelmann, 1956).

163 For a short and informative summary of *Weber's* account of the relationship between law and economic growth see Trubek, *Toward a Social Theory of Law: An Essay in the study of Law and Development*, 82 Yale L. J. 1, 11 et sqq. (1972).

164 Trubek (supra note 163), 82 Yale L. J. 1, 15 (1972).

165 See Djankov/Glaeser/La Porta/Lopez-de-Silanes/Shleifer (supra note 158).

> themselves secure in the possession of their property, in which the faith of contracts is not supported by law, and in which the authority of the state is not supposed to be regularly employed in enforcing the payment of debts from all those who are able to pay. Commerce and manufacturers, in short, can seldom flourish in any state in which there is not a certain degree of confidence in the justice of government."[166]

Similarly, *F. A. Hayek* underscored the importance of the rule of law's restraining function with respect to public authority for modern market economies and economic growth. For him, "[n]othing distinguishes more clearly conditions in a free country from those in a country under arbitrary government than the observance in the former of the great principles known as the Rule of Law."[167] In his reasoning, market economies are based on the initiatives and decision-making of individuals who, in order to be able to plan their economic efforts, require governmental actions to be restricted according to rules "made in advance, in the shape of formal rules which do not aim at the wants and needs of particular people [, but] are intended to be merely instrumental in the pursuit of people's various individual ends."[168]

While the function of legal institutions was initially mainly of interest in explaining the economic development of industrialized nations and was debated in the ideological conflict between liberalism and socialism, lawyers and social scientists took interest in institutional economics after decolonisation gained momentum after World War II in order to explain and remedy the economic weaknesses of many developing countries. In this context, the "law and development" movement focussed on the function of law in the Third World and its possible impact on sustainable economic growth.[169] In its core conception, the movement viewed "modern law […] as a functional prerequisite of an industrial economy", because it promoted the development of markets or, in a more state-centered view, enabled the state to use law as a tool to guide economic activity.[170] Notably, the concept of the rule of law figured prominently in the movement's theoretic framework.[171]

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166 Adam Smith, cited in Rodrik/Subramanian/Trebbi, *Institutions Rule: The Primacy of Institutions Over Geography and Integration in Economic Development*, 9 J. Econ. Growth 131 (2004). See also North/Weingast, *Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England*, 49 J. Econ. Hist. 803 (1989); De Long/Shleifer, *Princes and Merchants: European City Growth Before the Industrial Revolution*, 36 J. Law Econ. 671 (1993).

167 Hayek, *The Road To Serfdom*, p. 72 (1944).

168 Hayek (supra note 167), p. 73.

169 See for an overview of the law and development movement with further references e. g. Trubek (supra note 163), 82 Yale L. J. 1 (1972).

170 Trubek (supra note 163), 82 Yale L. J. 1, 6 et seq. (1972).

171 See Trubek/Galanter, *Scholars in Self-Estrangement: Some Reflections on the Crisis in Law and Development Studies in the United States*, 1974 Wisc. L. Rev. 1062, 1071 (1974); see also Trubek (supra note 163), 82 Yale L. J. 1, 6 et seq. (1972) with further references. Although the scholarly endeavors of the law and development movement ended quickly in the United States because the perspective it assumed was criticized as centered on Western thought and little receptive to the needs and traditions of third world countries, its legacy continued in other countries and was also influential with respect to the development efforts of international organisations

More recently, the linkage between institutions, growth and development is emphasized in new institutional economics. Scholars in this field particularly emphasize the significance of a well-functioning legal system that embodies the rule of law for economic growth and development. *Posner*, for instance, notes the "empirical evidence showing that the rule of law does contribute to a nation's wealth and its rate of economic growth."[172] This evidence is also buttressed by various theoretic economic analyses.[173]

The findings of new institutional economics have also been at the core of the development strategy of the World Bank. The linkage between the rule of law and economic development has, in particular, materialized in the Bank's legal reform program.[174] It has also been reiterated in the World Bank's good governance agenda, which comprises, as one of the core concepts that help to establish good government in developing countries, the rule of law. In its 1992 report on *Governance and Development* the Bank stated, although not in respect of foreign investment, that

> "[the] connection of the rule of law with efficient use of resources and productive investment, which must be understood and dealt with in highly specific and differentiated cultural and political settings, is the aspect most important to economic development, and hence to World Bank assistance."[175]

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within the United Nations system. For an overview of the history of the law and development movement see Tamanaha, *The Lessons of Law-and-Development Studies*, 89 A.J.I.L. 470, 472 et sqq. (1995).

172 Posner, *Creating a Legal Framework for Economic Development*, 13 The World Bank Research Observer 1, 3 (1998). For empirical analyses see De Soto, *The Other Path* (1989); De Long/Shleifer (supra note 166), 36 J. Law Econ. 671 (1993); Besley, *Property Rights and Investment Incentives: Theory and Evidence from Ghana*, 103 J. Pol. Econ. 903 (1995); Easterly/Levine, *Africa's Growth Tragedy: Policies and Ethnic Divisions*, 112 Q. J. Econ. 1203 (1997); Easterly/Levine, *Tropics, Germs, and Crops: How Endowments Influence Economic Development*, 50 J. Mon. Econ. 3 (2003); Knack/Keefer, *Institutions and Economic Performance: Cross Country Tests Using Alternative Institutional Measures*, 7 Econ. & Pol. 207 (1995); Acemoglu/Johnson/Robinson, *The Colonial Origins of Comparative Development: An Empirical Investigation*, 91 Am. Econ. Rev. 1369 (2001); Rodrik/Subramanian/Trebbi (supra note 166), 9 J. Econ. Growth 131 (2004).

173 For analyses in institutional economics see Hayek, *The Constitution of Liberty* (1960); Olson, *The Logic of Collective Action* (1965); Olson, *Power and Prosperity: Outgrowing Communist and Capitalist Dictatorships* (2000); Demsetz, *Towards a Theory of Property Rights*, 57 Am. Econ. Rev. 347 (1967); North, *Structure and Change in Economic History*, p. 201 et seq. (1981); North (supra note 156), p. 3 (1990); Posner, *Equality, Wealth, and Political Stability*, 13 J. L. Econ. & Org. 344 (1997), Barro, *Economic Growth in a Cross Section of Countries*, 106 Quart. J Econ. 407 (1991), Scully, *The Institutional Framework and Economic Development*, 96 J. Pol. Econ. 652 (1988).

174 See for an analysis of the economic underpinnings and the development strategy of the World Bank's law reform program from a critical perspective Tshuma, *The Political Economy of the World Bank's Legal Framework for Economic Development*, 8 Soc. & L. Stud. 75 (1999).

175 World Bank, *Governance and Development*, p. 28 (1992). The concept of the rule of law that the World Bank endorsed is a primarily procedural understanding that comprises five elements that are considered to be conducive to good governance and hence economic development. World Bank, p. 30 (1992): "(a) there is a set of rules known in advance, (b) the rules are actually in force, (c) there are mechanisms ensuring application of the rules, (d) conflicts are resolved through binding decisions of an independent judicial body, and (e) there are procedures for amending the rules when they no longer serve their purpose.".

While the economic literature consistently points to parallels and interdependencies between economic development and the emergence of stable and reliable institutions, the nature of the relationship between institutions and economic growth is debated, in particular whether, and if so to what extent, a causal relationship between institutions and growth exists.[176] From this perspective it is unclear whether the development of legal institutions, including the rule of law, will result in economic growth or whether, in turn, legal institutions are a result of prior economic development and the pressure exercised by the respective interests of economic actors. Yet, even if institutions do not trump all other factors in the quest for economic growth,[177] they nevertheless constitute one important factor for economic growth and development. In addition, the debate about a causal relationship between institutions and growth seems to be mitigated in the context of foreign investment by the fact that a certain institutional infrastructure that reduces the investment risk is necessary to attract foreign investment. Therefore the critique concerning the causality between institutions and growth seems to be less convincing than in a setting where growth is to be based solely on internal and self-induced economic activity.

Although the rule of law is surely not the only variable that influences economic growth,[178] institutional economics show the importance of the concept for economic growth and development. Consequently, it seems appropriate to draw a connection between the economic analysis of institutional economics, in particular its emphasis on the impact of the rule of law both on the microeconomics of foreign investors and its macroeconomic implications, and the normative framework of international investment treaties.[179] This gives a normative foundation for interpreting fair and equitable treatment as an embodiment of the concept of the rule of law since states presumably intended to establish institutions that effectively contribute to the object and purpose of international investment treaties.

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176 See, for example, Glaeser/La Porta/Shleifer (supra note 157), 9 J. Econ. Growth 271 (2004) denying a causal relationship and emphasizing the importance of human capital; emphasizing the importance of geography as the decisive factor for economic growth in developing countries Easterly/Levine (supra note 172), 50 J. Mon. Econ. 3 (2003). Arguing instead for a positive causal relationship see for example Rodrik/Subramanian/Trebbi (supra note 166), 9 J. Econ. Growth 131 (2004) or Acemoglu/Johnson/Robinson, (supra note 172), 91 Am. Econ. Rev. 1369, 1395 (2001).

177 In this sense Rodrik/Subramanian/Trebbi (supra note 166), 9 J. Econ. Growth 131 (2004).

178 See North, *Economic Performance Through Time*, 84 The American Econ. Rev. 359, 366 (1994): "[…] transferring the formal political and economic rules of successful Western economies to third-world and Eastern European economies is not a sufficient condition for good economic performance."

179 See also Schneiderman, *Investment Rules and the Rule of Law*, 8 Constellations 521 et seq. (2001) (arguing that "[t]he investment rules regime is intended to protect established investments abroad far into the future by locking countries into predictable regulatory frameworks. The objective is to bind states to a version of economic liberalism, to impose the discipline of the 'rule of law' on state regulation of the market; domestic rules are thereby rendered predictable and certain.").

V. Conclusion

Fair and equitable treatment has become one of the standard guarantees of protection in international investment treaties and is regularly applied by investment tribunals as a basis for ordering host states to pay damages to foreign investors. The scope given to it in recent investment arbitration is increasingly wide, covering restrictions of domestic courts, domestic administrative bodies and even the national legislator. This transforms fair and equitable treatment into a quasi-constitutional concept that overarches the activity of states that has effects on foreign investors. At the same time, arbitral tribunals and scholars in the field of investment protection and public international law frequently note the amorphous structure, the lack of a definition and, in more general terms, the lack of a conceptual understanding of the normative content of this wide-spread treaty standard.

The vagueness of the fair and equitable treatment standard constitutes structural problems for the principle's interpretation and construction by arbitral tribunals. While the arbitral jurisprudence continuously develops a more precise meaning of fair and equitable treatment, it nevertheless meanders around without any clear conceptual vision of the principle's function. The reasoning in arbitral awards is therefore often weak or even unconvincing in its legal analysis. It often restricts itself to invoking equally weakly reasoned precedent or refers in an inconclusive manner to the object and purpose of BITs without any deeper justification of how the specific construction contributes to the treaties' objective. Ultimately, these shortcomings endanger the suitability of fair and equitable treatment as a concept against which the conduct of host states can be measured. The main concern in this context is that the jurisprudence does not produce predictable results that are accepted by states but endorse an approach that allows for a broad *ex post facto* control of host state conduct. Predictability in its application is, however, essential for host states and foreign investors alike who need to know beforehand what kind of measures entail the international responsibility of the state and, accordingly, against which kind of political risks fair and equitable treatment protects.

In order to grasp the normative content of fair and equitable treatment, this article submitted that the standard can be understood as an embodiment of the rule of law. The survey of investment decision shows that the concept underlying fair and equitable treatment is functionally equivalent to the understanding of the requirements deduced from the rule of law under domestic legal systems. Investment tribunals have thus interpreted fair and equitable treatment to encompass sub-elements the rule of law is associated with in various domestic legal systems. In this respect, the jurisprudence of arbitral tribunals concerning fair and equitable treatment can be analyzed so as to include (1) the requirement stability and predictability of the legal framework and consistency in the host state's decision-making, (2) the principle of legality, (3) the protection of investor confidence or legitimate expectations, (4) procedural due process and denial of justice, (5) protection against discrimination and arbitrariness, (6) the requirement of transparency and (7) the concept of reasonableness and proportionality.

In its core, the rule of law understanding underlying the jurisprudence of investment tribunals can be described as primarily procedural and institutional in nature. Accordingly, the control exercised by investment tribunals over the conduct of host states is mainly concerned with the institutional structure and the procedural implementation of law and policy which affect foreign investors. Fair and equitable treatment, for example, requires the existence of a minimal separation of powers in host states, the possibility of recourse to courts for the adjudication of private rights and the review of acts of public authorities, legal security, protection of legitimate expectations and the observance of procedural rights in administrative and judicial proceedings. At the same time, such a procedural and institutional understanding of the rule of law allows states sufficient leeway in implementing their own substantive policy choices and in reacting to newly emerging circumstances, including state emergencies. Fair and equitable treatment does, however, not only influence the way host states change their regulatory frameworks as compared to the time the investment was made,[180] but in a more comprehensive way requires them to conform their domestic legal orders to standards that are internationally accepted as conforming to the concept of the rule of law. While, the paper only aimed at outlining the general features of a rule of law understanding of fair and equitable treatment and tried to explain the concept and function of this widely used treaty standard, the exact contours of the various sub-element still require further elaboration and context-specific analysis.

Arguably, such an understanding of fair and equitable treatment can be supported by an economic analysis of international investment treaties. This is particularly true considering the object and purpose of investment treaties that aim at protecting and *promoting* foreign investment flows and ultimately economic growth and development. This purposive link between the protection standards contained in the treaties and the promotion of investment justifies drawing a parallel to the economic literature that expands on the relationship between the rule of law and economic growth. The positive economic impacts that are linked to the rule of law and the incentive structure necessary for foreign investors to invest in a specific country suggest such an understanding of fair and equitable treatment as appropriate in the context of investment treaties. This can be buttressed by the assumption that states intended to have the most efficient structures implemented in order to promote investment flows. Finally, the paper suggest that tribunals should draw – in a comparative approach – on the jurisprudence of domestic and international courts on rule of law standards in order to further concretize fair and equitable treatment. This would help to convincingly justify and apply fair and equitable treatment in various context-specific fields of economic activity and state regulation. At the same time, the reference to rule of law concepts under domestic legal orders also illustrates that the rule of law is not an absolute guarantee but rather allows for a balance between the interests of host states and foreign investors. In this context, one should keep in mind the words of *Joseph Raz* who concluded his article on the *The Rule of Law and its Virtue* by recalling:

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[180] In this sense Dolzer (supra note 10), 39 Int'l Law. 87, 100 et sqq. (2005).

"After all the rule of law is meant to enable the law to promote social good, and should not be lightly used to show that it should not do so. Sacrificing too many social goals on the altar of the rule of law may make the law barren and empty."[181]

[181] Raz (supra note 41), 93 L. Quart. Rev. 195, 211 (1977).