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PUBLIC LAW CONCEPTS TO BALANCE  
INVESTORS' RIGHTS WITH STATE  
REGULATORY ACTIONS IN THE PUBLIC  
INTEREST—THE CONCEPT OF  
PROPORTIONALITY

*Benedict Kingsbury\* and Stephan W. Schill*

**I. Introduction**

Investment treaty arbitration is a growing field, with more than 300 treaty-based disputes publicly known and many new arbitrations being initiated each year.<sup>1</sup> At the same time, the cases related to the Argentine economic emergency,<sup>2</sup> and the stance taken by several other Latin American governments,<sup>3</sup> highlight concerns about the suitability and indeed the legitimacy of the existing system for dealing with certain situations, in particular when tensions between investment

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\* Benedict Kingsbury has written expert opinions in several cases, under ICSID and UNCITRAL Rules, at the request of the Government of Argentina.

<sup>1</sup> See UNCTAD, 'Latest Developments in Investor-State Dispute Settlement' (2010) IIA Issues Note No 1, 2–3, available at <[http://www.unctad.org/en/docs//webdiaeia20103\\_en.pdf](http://www.unctad.org/en/docs//webdiaeia20103_en.pdf)>, recording an aggregate of 357 treaty-based investment disputes by the end of 2009.

<sup>2</sup> Argentina's then Minister of Justice Rosatti, for example, was quoted after Argentina lost its first case relating to the emergency measures it took in reaction to the 2001–02 economic crises, ie *CMS v Argentina*, in 2005: 'We have been insisting that this tribunal is out of its depth here, that it is not prepared to handle such a quantity of cases involving a single country, that it has a pro-business bias, and that it is not qualified to judge a country's economic policy.' See BBC Monitoring Latin America—Political, supplied by BBC Worldwide Monitoring (17 May 2005).

<sup>3</sup> On 30 April 2008, Venezuela communicated to the Netherlands its intention to terminate the Dutch-Venezuelan bilateral investment treaty as of 1 November 2008. See LE Peterson (ed), 'Investment Arbitration Reporter' (16 May 2008), available at <<http://www.iareporter.com/Archive/IAR-05-16-08.pdf>>, reporting that Venezuela had chosen to end the treaty citing reasons of 'national policy'. Bolivia withdrew from the ICSID Convention as of 3 November 2007. See 'Bolivia Denounces ICSID Convention' 46 ILM 973 (2007). On 12 June 2009, Ecuador's Congress voted to withdraw from the ICSID Convention. Discussion of withdrawal from the ICSID Convention also has been reported with respect to Nicaragua, Venezuela, and Cuba. See ME Schnabl and J Bédard, 'The Wrong Kind of "Interesting"' National Law Journal, 30 July 2007.

protection and competing rights and interests are at issue.<sup>4</sup> Even traditional capital-exporting countries, like the United States, are becoming increasingly apprehensive about the restrictions that investment treaties and investment treaty arbitration impose on their regulatory powers. The United States' experience with Chapter 11 of NAFTA, for example, has had a direct influence on the attitudes of the United States in more recent free trade agreement and BIT negotiations, and led to modifications to the US model BIT.<sup>5</sup>

Part of the reason for these concerns is that investment treaties only impose substantive obligations on host states, without matching these investors' rights with investors' obligations; in addition, most investment treaties do not explicitly list conditions under which the host state can restrict investors' rights (as is done in many human rights treaties); nor do they usually define classes of exceptions to the protection granted to foreign investors (as, for example, in Article XX of GATT). One anxiety therefore is that tribunals, because of the open-ended language of the investors' rights, may abridge the role of states as regulators, and in particular give too little weight to the justification of certain abstract and general regulations undertaken to protect the public interest, whether for environmental protection, human rights, or to meet emergencies. This is aggravated by continued unpredictability in the interpretation of standard concepts of investment law

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<sup>4</sup> Numerous works in the field argue that there is, or may soon develop, a 'legitimacy crisis' in investor-state arbitration, variously referring to problems such as the design of the dispute settlement mechanism based on ad hoc arbitration with the ensuing risk of inconsistent decisions, the vagueness and ambiguity of many of the core rights conferred on investors, and the perceived blindness of arbitral tribunals to matters which they do not see as related to investment. See CN Brower, 'A Crisis of Legitimacy' *National Law Journal*, 7 October 2002; CH Brower II, 'Structure, Legitimacy, and NAFTA's Investment Chapter' (2003) 36 *Van JTL* 37; CN Brower *et al*, 'The Coming Crisis in the Global Adjudication System' (2003) 19 *Arb Int* 415; A Afilalo, 'Towards a Common Law of International Investment: How NAFTA Chapter 11 Panels Should Solve Their Legitimacy Crisis' (2004) 17 *Geo IELR* 51; A Afilalo, 'Meaning, Ambiguity and Legitimacy: Judicial (Re-)construction of NAFTA Chapter 11' (2005) 25 *Nw JILB* 279, 282; M Sornarajah, 'A Coming Crisis: Expansionary Trends in Investment Treaty Arbitration' in KP Sauvart (ed), *Appeals Mechanism in International Investment Disputes* (2008) 39–45; G Van Harten, *Investment Treaty Arbitration and Public Law* (2007); O Chung, 'The Lopsided International Investment Law Regime and Its Effect on the Future of Investor-State Arbitration' (2007) 47 *Van JIL* 953, arguing that existing bilateral investment treaties strongly favour investors and that these inequalities will eventually lead to greater difficulties in the enforcement of such treaties; N Gurudevan, 'An Evaluation of Current Legitimacy-based Objections to NAFTA's Chapter 11 Investment Dispute Resolution Process' (2005) 6 *San Diego ILJ* 399.

<sup>5</sup> See K Vandevelde, 'A Comparison of the 2004 and 1994 U.S. Model BITs: Rebalancing Investor and Host Country Interests' (2008/2009) 1 *Yearbook of International Investment Law and Policy* 283; G Gagné and J-F Morin, 'The Evolving American Policy on Investment Protection: Evidence from Recent FTAs and the 2004 Model BIT' (2006) 9 *Ji Econ L* 357, 363; M Kantor, 'The New Draft Model U.S. BIT: Noteworthy Developments' (2004) 21 *Ji Arb* 383, 385; S Schwebel, 'The United States 2004 Model Bilateral Investment Treaty: An Exercise in the Regressive Development of International Law' (2006) 3(2) *Trans Disp Man*. See generally G Aguilar Alvarez and WW Park, 'The New Face of Investment Arbitration: NAFTA Chapter 11' (2003) 28 *Yale JIL* 365, discussing the phenomenon of developed countries as respondents in investment treaty arbitration.

with some awards not only endorsing but perhaps even celebrating a broad *ex post facto* 'I will know it when I see it' control of host state conduct.<sup>6</sup>

At the same time, the focus in investment treaty arbitration on investment-related matters is perceived as a threat to the effectiveness of other international legal regimes, in particular those relating to the protection of human rights and the environment. The concern is that investment tribunals frequently craft the vague standards of international investment law, such as fair and equitable treatment or the concept of indirect expropriation, in the limited context of investor claims and develop international investment law without adequate engagement with other bodies of international law. In particular tribunals often (although with some notable exceptions) make little effort to coordinate with standards of good administration imposed on states by the World Trade Organization (WTO) for trade-related governmental actions, or by international human rights tribunals, or by international financial and aid institutions concerning loan conditions.

This chapter addresses the challenges that arise as investor-state arbitration proceedings and awards increasingly have to address, and face criticism concerning their lack of responsiveness to, environmental considerations, labour and social standards, and governmental management of economic crises or other fundamental issues for entire populations. Argentina's emergency suspension of tariff increases and of peso convertibility, Bolivia's cancellation of the Bechtel water contract after riots, Ontario's refusal to proceed with a scheme to dump Toronto's refuse into a lake, or Costa Rica's prohibition of development on a foreign-owned ranch because of its proclamation of a nature reserve, are among numerous examples of conflicts between investment protection and competing public concerns. Bailouts, subsidies, and other emergency measures taken in response to the global financial crisis that developed in 2008–09, and to subsequent financial crises in Greece and elsewhere, raise similar issues. In such situations investor-state arbitral tribunals are called upon to weigh a measure taken by a state in exercise of its regulatory power, against the economic damage done to a foreign investor by that measure.

Public law concepts arguably can help to address the concerns arising in this respect and accommodate the impact of non-investment related matters within the system of international investment law and arbitration. While the conceptual approaches used by investment tribunals to deal with conflicts between investors' rights and other public interests often appear insufficient, arbitral tribunals could draw on public law concepts used in various other international and national courts and tribunals, notably by having recourse to proportionality analysis in order to balance rights and rights-limiting policy choices. The present chapter

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<sup>6</sup> cf in the context of defining the concept of indirect expropriation, Y Fortier and SL Drymer, 'Indirect Expropriation in the Law of International Investment: I Know It When I See It, or Caveat Investor' (2004) 19 ICSID Rev–FILJ 293.

therefore discusses how proportionality analysis can be accommodated—and by some tribunals has already been employed—as an interpretation technique for principles of international investment law that is in line with the approaches taken in different dispute settlement bodies to solving conflicts of competing rights and interests. It argues that this may be a permitted and even necessary element of investment treaty interpretation and application in some cases, and can be accommodated, for example, within the ambit of legal concepts of indirect expropriation and fair and equitable treatment, whenever the restriction of the state's regulatory leeway is at play.

Proportionality analysis is not proposed as an alternative to the rules on treaty interpretation under the Vienna Convention on the Law of Treaties (VCLT), but rather as informing the exercise of interpreting a treaty with a view to resolving conflicts between competing rights and interests when the rules of treaty interpretation do not indicate priority of one right or interest over the other.<sup>7</sup> It suggests that arbitral tribunals may indeed have little choice but to adopt approaches that are similar to those adopted by domestic courts and other international courts and tribunals when faced with comparable conflicts between important interests that must all be weighed in the legal appraisal. While use of a proportionality approach may have significant problems—in particular because it risks reposing more governance powers in such tribunals and making more demands on them than may be desirable—in the long run, the application of proportionality analysis is congruent with an emerging set of public law principles for global regulatory governance.

Proportionality analysis thus facilitates balancing between interests of foreign investors, or more generally property rights, and conflicting public interests. While proportionality analysis can no doubt be susceptible to use as a means to justify particular judicial preferences, when deployed by sophisticated courts and tribunals in national and international jurisprudence to deal with open-ended concepts and difficult balancing, it has proved to be methodologically workable and more coherent and generalizable than the kinds of reasoning applied by many tribunals to fair and equitable treatment clauses or to the concept of indirect expropriation. The diversity of existing uses of proportionality analysis means that it is possible to undertake wide-ranging and instructive comparative law

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<sup>7</sup> This limits the scope of application of proportionality analysis as a legal technique. Thus, cases where the state acts as a party to an investor-state contract will usually be subject to the constraints of what was agreed. But see on limitations to the power of states in their capacity as a party to a contract, S Schill, 'Umbrella Clauses as Public Law Concepts in Comparative Perspective', Chapter 10 below, 317. Furthermore, proportionality reasoning and analysis may not apply in certain situations in which decisive controlling rules of priority between property interests and competing non-property interests are already clearly established, or can be interpreted to exist, based on the applicable rules of treaty interpretation under the VCLT. Proportionality analysis, however, finds a major field of application in cases where the state itself redistributes or interferes with property rights in the interest of protecting some non-economic interest by means of general legislation or administrative regulation.

research and analysis as to what is considered as proportional in various national legal systems and by transnational or international tribunals. Despite the lack of express textual provision in most investment treaties, states continue to dispose of their core regulatory powers and are not required to compensate foreign investors for the effects of bona fide, general regulations that further a legitimate purpose in a non-discriminatory and proportionate way. This may alleviate the concerns that investment law is blind towards non-investment policy choices and is isolated vis-à-vis other international legal regimes aiming at the protection of important non-investment related public interests.

In addition, the principle of proportionality may in some respects provide a stricter framework for decisions in investor-state disputes than does the current jurisprudence. It requires arbitrators to engage in a method of assessing the competing legal claims, weighing them, considering alternatives, and reaching determinations supported by rational arguments for their decisions.

## II. The Development and Diffusion of Proportionality Analysis

Proportionality analysis is a method of legal interpretation and decision-making in situations of collisions or conflicts of different principles and legitimate public policy objectives. It is characteristic of this approach to distinguish principles on the basis that they do not work in an ‘all-or-nothing fashion’, but allow for a ‘more or less’.<sup>8</sup> While rules ‘contain fixed points in the field of the factually and legally possible’, ie a rule is a norm that is either ‘fulfilled or not’,<sup>9</sup> principles operate differently in that they aim at ‘commanding that something be realized to the highest degree that is actually and legally possible’.<sup>10</sup> As one of the great German exponents of proportionality commented: ‘Conflicts of rules are played out at the level of validity’, whereas ‘competitions between principles are played out in the dimension of weight’.<sup>11</sup> There is, by contrast, tempered enthusiasm for proportionality analysis among US judges,<sup>12</sup> and historically also in systems influenced by English law, although the process of European integration is having its effects, for

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<sup>8</sup> R Dworkin, *Takings Rights Seriously* (1978) 24.

<sup>9</sup> R Alexy, *A Theory of Constitutional Rights* (1986, 2002, Julian Rivers (trans)) 47–8.

<sup>10</sup> R Alexy, ‘On the Structure of Legal Principles’ (2000) 13 *Ratio Juris* 294, 295. See also Alexy (n 9 above) 47, stating that principles are norms that ‘require that something be realized to the greatest extent possible given the legal and factual possibilities’.

<sup>11</sup> Alexy (n 9 above) 50.

<sup>12</sup> Concerning the scope of the proportionality requirement in US constitutional law in particular concerning criminal law in the context of the Eighth Amendment, see A Ristroph, ‘Proportionality as a Principle of Limited Government’ (2005) 55 *Duke LJ* 263, with further references; see also on the hesitance in US constitutional law to accept proportionality as a general principle VC Jackson, ‘Ambivalent Resistance and Comparative Constitutionalism: Opening up the Conversation on “Proportionality”, Rights And Federalism’ (1999) 1 *UPa J Const L* 583.

example, in the United Kingdom. Notwithstanding, proportionality analysis is increasingly recognized in national and international legal regimes of public law. This section therefore provides basic illustrations of national and international juridical institutions applying proportionality analysis to state action impinging on other rights. The aim is simply to show that the emergence of a general principle may be involved. It is fundamental to emphasize that there are essential differences between the institutional settings, and between the underlying texts, so the precise analysis and background assumptions can not be transposed even from one international treaty body to another.

At its origin in the domestic law context, proportionality entails a method of defining the relationship between the state and its citizens or other legal persons. It helps to resolve conflicts between, on the one hand, the rights of individuals and the interest of the state and, on the other, between conflicting rights of individuals. Proportionality 'sets material limits to the interference of public authorities into the private sphere of the citizen'<sup>13</sup> and 'provide[s] a tool to define and restrain the regulatory freedom of governments'.<sup>14</sup> It helps to define and to balance the public, represented by the interference and the underlying interest of the state or the community concerned, and the private, represented by the interests of the individuals affected.

Proportionality balancing is a concept stemming from German administrative and constitutional law. It has migrated from these roots as a mode of balancing between competing rights and interests to numerous jurisdictions in South America, Central and Eastern Europe, as well as to various common law jurisdictions.<sup>15</sup> At the outset, the German Constitutional Court (*Bundesverfassungsgericht*) formulated the test of proportionality for the first time in its seminal *Apothekenurteil*, a case concerning the interference with the freedom of profession of pharmacists by a licensing system that limited the number of pharmacy licences in order to secure the supply of the population with pharmaceuticals. In solving the underlying conflict of rights, the German Constitutional Court stated that the individual right and the public purpose of the law had to be balanced:

The constitutional right has the purpose to protect the freedom of the individual, while exceptions to its regulation ensure sufficient protection of societal interests. The individual's claim to freedom will have... a stronger effect, the more his right to free choice of a profession is put into question; the protection of the public will become more and more urgent, the greater the disadvantages that arise from freely practicing the profession become. When one seeks to maximize both... demands in

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<sup>13</sup> J Schwarze, 'The Principle of Proportionality and the Principle of Impartiality in European Administrative Law' (2003) 1 *Rivista Trimestrale di Diritto Pubblico* 53.

<sup>14</sup> M Andenas and S Zleptnig, 'Proportionality: WTO Law in Comparative Perspective' (2007) 42 *Tex ILJ* 371, 383.

<sup>15</sup> See on this and the following, A Stone Sweet and J Mathews, 'Proportionality Balancing and Global Constitutionalism' (2008) 47 *Col JTL* 72.

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the most effective way, then the solution can only lie in a careful balancing [*Abwägung*] of the meaning of the two opposed and perhaps conflicting interests.<sup>16</sup>

The Supreme Court of Canada has applied a very similar proportionality test since *Regina v Oakes*, a case that concerned the question of whether a provision of the Narcotics Act was in conformity with Canada's Charter of Rights and Freedoms in establishing a rebuttable presumption that a person found to be in possession of drugs was trafficking drugs and thus criminally liable. The Court struck down this provision as violating the presumption of innocence enshrined in the Charter and based its analysis on a three-step 'proportionality test':

First, the measures adopted must be carefully designed to achieve the objective in question. They must not be arbitrary, unfair or based on irrational considerations. In short, they must be rationally connected to the objective. Second, the means, even if rationally connected to the objective in this first sense, should impair 'as little as possible' the right or freedom in question. Third, there must be a proportionality between the effects of the measures which are responsible for limiting the Charter right or freedom, and the objective which has been identified as of 'sufficient importance'.<sup>17</sup>

To give one further example, the Constitutional Court of South Africa also applies a test of proportionality in balancing individual rights and government purposes. In *State v Makwanyane*, the Court was faced with a challenge to the death penalty as violating the constitutional right against cruel, inhuman, and degrading punishments. The Court, through its leading opinion by President Chaskalson, decided to solve the conflict based on a proportionality analysis: 'The limitation of constitutional rights for a purpose that is reasonable and necessary in a democratic society involves the weighing up of competing values, and ultimately an assessment based on proportionality.'<sup>18</sup> The Court considered that the following factors would need to be taken into account:

In the balancing process, the relevant considerations will include the nature of the right that is limited, and its importance to an open and democratic society based on freedom and equality; the purpose for which the right is limited and the importance of that purpose to such a society; the extent of the limitation, its efficacy, and particularly where the limitation has to be necessary, whether the desired ends could reasonably be achieved through other means less damaging to the right in question.<sup>19</sup>

Proportionality has also been routinely applied in the context of international legal regimes as a technique for delineating and balancing the conflicting interests of the international legal order and domestic public policy. In the context of the EC/EU, for example, the concept of proportionality has been used by the European Court of Justice (ECJ) to balance the Community's fundamental

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<sup>16</sup> BVerfGE 7, 377, 404–5.

<sup>17</sup> *R v Oakes* [1986] 1 SCR 103, 139.

<sup>18</sup> *State v Makwanyane and anor* 1995 (3) SA 391, 436 (CC).

<sup>19</sup> *ibid.*

freedoms—the free movement of goods, services, labour, and capital—with conflicting legitimate interests of the Member States.<sup>20</sup> For example, in the *Cassis de Dijon* case the ECJ decided that the free movement of goods, guaranteed in Article 28 TFEU, could be violated not only by discriminatory regulations of a Member State, but also through non-discriminatory regulations that limited intra-Community trade. At the same time, however, and as a corollary to this broad understanding of the fundamental freedom, the Court recognized that Member States could limit the free movement of goods in the public interest where necessary if this interest constituted a so-called ‘mandatory requirement’. The Court held that:

Obstacles to movement within the community resulting from disparities between the national laws relating to the marketing of the products in question must be accepted in so far as those provisions may be recognized as being necessary in order to satisfy mandatory requirements relating in particular to the effectiveness of fiscal supervision, the protection of public health, the fairness of commercial transactions and the defence of the consumer.<sup>21</sup>

Even though this test is formulated as a necessity test focusing on less restrictive alternatives, the Court applies it in a way very similar to the proportionality tests described earlier on with respect to the domestic courts.

Similarly, the ECJ and the Court of First Instance (now called the General Court) require that measures of the Community vis-à-vis Member States, and those affecting individuals subject to the Community legal order, are to be evaluated against the standard of proportionality. The Court of First Instance, for example, explained in a case concerning the review of a Community act that:

... the principle of proportionality, which is one of the general principles of Community law, requires that measures adopted by Community institutions should not exceed the limits of what is appropriate and necessary in order to attain the legitimate objectives pursued by the legislation in question, and where there is a choice between several appropriate measures, recourse must be had to the least onerous, and the disadvantages caused must not be disproportionate to the aims pursued.<sup>22</sup>

In the jurisprudence of the ECJ, proportionality is thus used to ‘manag[e] tensions and conflicts between rights and freedoms, on the one hand, and the power of the EC/EU and of Member States, on the other’.<sup>23</sup> It therefore not only constitutes a method for delimiting individual rights and the Member State’s right to limit

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<sup>20</sup> See also E Ellis (ed), *The Principle of Proportionality in the Laws of Europe* (1999); on proportionality as a principle in EU/EC law, N Emiliou, *The Principle of Proportionality in European Law: A Comparative Study* (1996) 23 *et seq*; G Nolte, ‘General Principles of German and European Administrative Law—A Comparison in Historic Perspective’ (1994) 57 MLR 191; see also TJ Gunn, ‘Deconstructing Proportionality in Limitations Analysis’ (2005) 19 Emory ILR 465.

<sup>21</sup> Case 120/78 *Cassis de Dijon* [1979] ECR 649, para 8, Judgment, 20 February 1979.

<sup>22</sup> Case T-13/99 *Pfizer Animal Health SA v Commission* [2002] ECR II-3305, para 411, Judgment, 23 November 2002 (citing [1990] ECR I-4023, para 13).

<sup>23</sup> Stone Sweet and Mathews (n 15 above) 144.

such rights, but also ‘a mechanism of coordination between the supranational legal order and national legal orders’.<sup>24</sup>

In other areas of public international law proportionality plays a similar role in resolving conflicts in the relations between equal sovereigns. In the law of countermeasures, proportionality is used to limit the reaction against a state breach of international law by another state.<sup>25</sup> Here, proportionality limits both the means and the scope of the countermeasures applied.<sup>26</sup> In particular, the countermeasure must not be tailored so as to permanently deprive the state in breach of its fair share of benefits. As the International Court of Justice (ICJ) stated in the *Gabčíkovo-Nagymaros* case: ‘the effects of a countermeasure must be commensurate with the injury suffered, taking account of the rights in question’.<sup>27</sup> Likewise, proportionality is an element of the legality of the use of force in the context of the right to self-defence. Even though not appearing explicitly in Article 51 of the UN Charter, it has been held by the ICJ to constitute part of customary international law according to which ‘self-defence would warrant only measures which are proportional to the armed attack and necessary to respond to it’.<sup>28</sup>

The ICJ also adopted proportionality reasoning in balancing the right of a state to regulate navigation on a river belonging to its territory with the right to free navigation granted by international treaty to the neighbouring country. Thus, in the *Case Concerning the Dispute Regarding Navigational Rights*, the Court concluded:

... that Nicaragua has the power to regulate the exercise by Costa Rica of its right to freedom of navigation under the 1858 Treaty. That power is not unlimited, being tempered by the rights and obligations of the Parties. A regulation in the present case is to have the following characteristics:

- (1) it must only subject the activity to certain rules without rendering impossible or substantially impeding the exercise of the right of free navigation;
- (2) it must be consistent with the terms of the Treaty, such as the prohibition on the unilateral imposition of certain taxes in Article VI;
- (3) it must have a legitimate purpose, such as safety of navigation, crime prevention and public safety and border control;
- (4) it must not be discriminatory and in matters such as timetabling must apply to Nicaraguan vessels if it applies to Costa Rican ones;

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<sup>24</sup> *ibid.*

<sup>25</sup> TM Franck, ‘On Proportionality of Countermeasures in International Law’ (2008) 102 *AJIL* 715.

<sup>26</sup> E Cannizaro, ‘The Role of Proportionality in the Law of International Countermeasures’ (2001) 12 *EJIL* 889, 897.

<sup>27</sup> *Gabčíkovo-Nagymaros Project (Hungary/Slovakia)* Judgment, 25 September 1997, ICJ Reports 1997, 7, para 85.

<sup>28</sup> *Military and Paramilitary Activities in and against Nicaragua (Nicaragua v US)* Judgment, 27 June 1986, ICJ Reports 1986, 14, paras 176 and 194; see also *Legality of the Threat or Use of Nuclear Weapons* Advisory Opinion, 8 July 1996, ICJ Reports 1996, 226, para 41, stating more generally: ‘The submission of the exercise of the right of self-defence to the conditions of necessity and proportionality is a rule of customary international law.’

- (5) it must not be unreasonable, which means that its negative impact on the exercise of the right in question must not be manifestly excessive when measured against the protection afforded to the purpose invoked.<sup>29</sup>

Under WTO law, proportionality analysis also plays a role in balancing the objectives of the international trade regime, notably trade liberalization, non-discrimination in the trade context, and the limitation and careful assessment of non-tariff barriers to trade, with conflicting and legitimate government purposes such as the protection of public health, public morals, or the environment, many but not all of which are enumerated in Article XX of GATT. Even though WTO scholars maintain that no uniform proportionality analysis has developed in the jurisprudence of the Dispute Settlement Body to balance trade and non-trade interests,<sup>30</sup> the various balancing tests applied in this context can nevertheless be framed, on an abstract level, as a type of proportionality analysis.

In *Korea Beef*, for example, a case concerning the labelling and sale of beef depending on its origins as Korean or non-Korean beef in order to protect public health, the Appellate Body explained that:

The more vital or important . . . common interests or values are, the easier it would be to accept as 'necessary' a measure designed as an enforcement instrument. There are other aspects of the enforcement measure to be considered in evaluating that measure as 'necessary'. One is the extent to which the measure contributes to the realization of the end pursued, the securing of compliance with the law or regulation at issue. The greater the contribution, the more easily a measure might be considered to be 'necessary' . . . [The] [d]etermination of whether a measure, which is not 'indispensable', may nevertheless be 'necessary' within the contemplation of Article XX(d), involves in every case a process of weighing and balancing a series of factors which prominently include the contribution made by the compliance measure to the enforcement of the law or regulation at issue, the importance of the common interests or values protected by that law or regulation, and the accompanying impact of the law or regulation on imports or exports.<sup>31</sup>

Finally, proportionality analysis plays a crucial role in the jurisprudence of the European Court of Human Rights (ECtHR) in its application of the European Convention on Human Rights and Fundamental Freedoms (ECHR), notably as regards the resolution of conflicts between individual rights granted under the Convention and public policies of the Member States. Even though the Convention

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<sup>29</sup> *Case Concerning the Dispute Regarding Navigational Rights (Costa Rica v Nicaragua)* Judgment, 13 July 2009, para 87, available at <<http://www.icj-cij.org>>.

<sup>30</sup> See A Desmedt, 'Proportionality in WTO Law' (2001) 4 JI Econ L 441.

<sup>31</sup> *Korea—Measures Affecting Imports of Fresh, Chilled and Frozen Beef* WT/DS161/AB/R, Report of the Appellate Body, 11 December 2000, para 164. Note, however, that this case goes beyond the approach taken to proportionality by the WTO Appellate Body in most of its other cases. The Appellate Body usually has not invoked common interests or values in such a clear-cut way as a basis for evaluating a state's actions, and it has usually preferred to use interpretative techniques rather than to apply explicitly the third stage of proportionality analysis, ie proportionality *stricto sensu*.

requires, for example, with respect to restrictions of the freedom of expression only that a state measure be ‘necessary in a democratic society’, the Court developed this into a proportionality analysis similar to the one found in German constitutional law. In its leading case of *Handyside v United Kingdom*, a case involving censorship of a book based on violations of public morals, the Court stated that ‘the adjective “necessary”, within the meaning of Article 10 para. 2 is not synonymous with “indispensable” [and] neither has it the flexibility of such expressions as . . . “admissible”, . . . “useful”, “reasonable”, or “desirable”’.<sup>32</sup> Later on, in *Dudgeon v United Kingdom*, the Court declared a state measure that criminalized certain homosexual conducts ‘disproportionate’ in interfering with the right to privacy.<sup>33</sup> Meanwhile, the Court has engaged in proportionality-style balancing with respect to almost every right enshrined in the Convention.<sup>34</sup>

At the same time, however, the Court grants, as stated in the *Handyside* case, a margin of appreciation to the Member States in ‘mak[ing] the initial assessment of the pressing social need implied by the notion of “necessity” in this context’.<sup>35</sup> It is for them to determine in the first place what they consider necessary for a democratic society and it is this choice that the ECtHR subjects to scrutiny. The margin varies depending on the right involved, the government purpose pursued, and the degree of interference. Similar to the function of proportionality in the EU context, proportionality analysis by the Strasbourg Court has to be seen not only in balancing individual rights and public interests, but also as ‘a basic mechanism of coordinating between the ECHR and national legal systems, and among diverse national systems’.<sup>36</sup>

### III. The Structure of Proportionality Analysis

Proportionality addresses the relationship between the ends pursued by a specific government action and the means employed to achieve this end.<sup>37</sup> Certainly, major differences exist between various versions and methodologies of proportionality analysis, including differences between fully-fledged proportionality that involves a substantive review by the adjudicator of the balance struck in the decision under scrutiny and a more procedural type of review, such as less- or least-restrictive-measures tests.<sup>38</sup> The balancing between conflicting rights and interests depends also on the cultural socializations and values connected to a

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<sup>32</sup> *Handyside v UK* Judgment, 7 December 1976, ECHR Series A, No 24, para 48.

<sup>33</sup> *Dudgeon v UK* Judgment, 22 October 1981, ECHR Series A, No 45.

<sup>34</sup> J Rivers, ‘Proportionality and Variable Intensity of Review’ (2006) 65 Camb LJ 174, 182. The Court particularly engaged in a heavy critique of the more lenient reasonableness standards initially applied by the courts in the UK, see Stone Sweet and Mathews (n 15 above) 145–52.

<sup>35</sup> *ibid.* <sup>36</sup> *ibid* 151. <sup>37</sup> See Emiliou (n 20 above) 23–4.

<sup>38</sup> Andenas and Zleptnig (n 14 above) 388.

specific institution, its hermeneutics, and the core legal texts, other legal materials, as well as the purposes of the specific legal regime. Notwithstanding such variance, as a general matter proportionality analysis provides a guiding structure for decision-makers that requires them to address certain issues and to determine whether measures taken by a state have sufficiently taken into account the rights or interests they interfere with. As developed in the jurisprudence of various domestic and international courts, proportionality analysis can be described as comprising three sub-elements: (1) the principle of suitability, (2) the principle of necessity, and (3) the principle of proportionality *stricto sensu*.

### **A. Suitability for a Legitimate Government Purpose**

The first step in proportionality reasoning is the analysis of whether the measure adopted by the state or government agency serves a legitimate government purpose and is generally suitable to achieve this purpose. The task the decision-maker has to achieve is thus two-fold, although both elements of this first step set a relatively undemanding standard for the state measure to meet, certainly in the context of investor-state arbitration. The first element of the task is to ascertain whether the measure adopted aims at a legitimate purpose. Consequently, illegitimate purposes can be filtered out at this early stage. They constitute *per definitionem* a disproportionate interference with the right or interest protected.

In investor-state arbitration, most ordinary public purposes of state action will be legitimate purposes, and only in marginal cases will it be necessary to assess the legitimacy of the purpose based on a comparative approach or from its recognition in international treaties. A state action that is manifestly corrupt for the purely private benefit of a crony, or that is a *jus cogens* violation such as crimes against humanity, is obviously not taken for a legitimate purpose. Overall, however, very few state measures will fail to meet the legitimate government purpose test.

After establishing the legitimacy of the purpose pursued, the decision-maker will have to determine, in the second element of its task, whether the measure taken is suitable to achieve the stated aim. This requires the establishment of 'a causal relationship between the measure and its object'.<sup>39</sup> The decision-maker will thus have to determine whether the measure furthers the stated purpose in any way. Again, only very few measures will not pass this part of the suitability test, as good faith actions by governments will usually not involve the use of means that are wholly ineffective in pursuing the stated purpose.

### **B. Necessity**

In a second step, proportionality analysis involves a test of necessity. This covers the question of whether there are other, less intrusive means with regard to the

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<sup>39</sup> JH Jans, 'Proportionality Revisited' (2000) 27 *Legal Issues of Economic Integration* 239, 240.

right or interest affected that are equally able to achieve the stated goal (without infringing other protected interests). Necessity requires that there is no less restrictive measure that is equally effective.<sup>40</sup> This step requires answering two questions: first, is there a less restrictive measure, and secondly, is this measure equally effective (and reasonably feasible)? The background to this test can again be seen in the optimization the decision-maker has to achieve when balancing conflicting principles.<sup>41</sup> If the right affected is protected in principle, there is no justification for the state to be allowed to infringe upon such rights more than necessary, since there are other equally effective alternatives to achieve the same aim.

### C. Proportionality *stricto sensu*

In a final step, proportionality analysis involves a balancing between the effects of the state measure on the affected right or interests and the importance of the government purpose. Proportionality *stricto sensu* requires that the measure is not excessive with regard to the objective pursued and that relative weight is given to each principle.<sup>42</sup> 'The greater the degree of non-satisfaction of, or detriment to, one principle, the greater must be the importance of satisfying the other.'<sup>43</sup> Proportionality *stricto sensu* requires taking into account all relevant factors such as cost-benefit analysis, the importance of the right affected, the importance of the right or interest protected, the degree of interference (minor versus major interference), the length of interference (permanent versus temporary), the availability of alternative measures that might be less effective, but are proportionally less restrictive for the right affected, and so on.

This third step is apposite because an analysis that stops at the necessity-stage would allow the severe restriction of a right in order to protect a negligible public interest.<sup>44</sup> A feature of this type of reasoning compared to more deferential standards is that the judge or decision-maker is required to go through an exercise in creative problem-solving that attempts to relate the purpose pursued and the importance of the rights affected. It requires the adjudicator actively to consider alternative policies which could have resulted in a better optimization of the two conflicting rights or interests involved, instead of just assessing their reasonableness, which is a standard that would necessarily be more deferential to government policy-making, but also accord less protection to the rights protected.

This does not mean, however, that the adjudicator should substitute its own preferences for those of the government, but merely that it should constrain interferences

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<sup>40</sup> *ibid.*      <sup>41</sup> cf. Alexy (n 9 above) 399.

<sup>42</sup> Alexy (n 10 above) 13 *Ratio Juris* 294, 298.

<sup>43</sup> Alexy (n 9 above) 102.

<sup>44</sup> R von Krauss, *Der Grundsatz der Verhältnismäßigkeit in seiner Bedeutung für die Notwendigkeit des Mittels im Verwaltungsrecht* (1955) 15, stating that 'if the measure [of legality] is only necessity' (ie the least restrictive means test), then 'a quite negligible public interest could lead to a severe right infringement, without being unlawful'.

by considering whether the reasoning and policy objectives of the government action stay within a framework that is based on the recognition of various, eventually conflicting rights or interests that the state tries generally to protect. Depending on the interpretive issues and legal norms involved, all the adjudicator might be allowed to do, for example, is verify whether the state has stayed in a basically proportionate manner within an outer framework that is spanned by the recognition of property and investment protection, on the one hand, and the legitimate public interest, on the other.

#### **IV. Applying Proportionality Analysis in Investor-State Arbitration**

Fundamental to the application of proportionality analysis (and comparable techniques of balancing) in investment treaty arbitration is the question of the relationship of proportionality analysis to the applicable law, and in particular to the applicable international law.<sup>45</sup> The starting point is the good faith interpretation of the applicable treaty. A particular feature of most investment treaties is that they make provisions for investor rights without addressing in a comprehensive fashion the relationship of these to continuing powers of state regulation. It is likely that state parties typically did not intend a severe occlusion of these regulatory powers, and a good faith reading of the text of the applicable treaty in its context and in the light of the object and purpose of the treaty may well indicate that interpretation calls for a balance to be struck between investor protection and state regulatory powers. In interpreting the text of the treaty in order to be able to apply it to a specific dispute, the interpreter may well have recourse to other relevant rules of international law applicable between the parties to the treaty (Article 31(3)(c) of VCLT), potentially including general principles of law. In this way, application of the principle of proportionality can be consistent with, and a form of, the interpretation and application of the substantive provisions of investment treaties. It can arguably provide a rational process for weighing and balancing that can itself be grounded in the proper interpretation of investment treaties.<sup>46</sup>

Investment tribunals are beginning to adopt (albeit not frequently yet) proportionality analysis. This is particularly evident in three sets of cases which will be discussed in this section. One concerns the question of how to delineate between indirect expropriations that require compensation and non-compensable

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<sup>45</sup> Where a tribunal analyses or applies national law, the use of proportionality analysis or other balancing techniques in a particular area of national law may of course be directly relevant, but that is not the focus of the discussion here.

<sup>46</sup> See *MTD Equity Sdn Bhd and MTD Chile SA v Republic of Chile* ICSID Case No ARB/01/7, Award, 25 May 2004, para 113; *Saluka Investments BV v The Czech Republic* UNCITRAL, Partial Award, 17 March 2006, para 297.

regulation. Another concerns the issue, dealt with in the context of the fair and equitable treatment standard, of the extent to which the investor's legitimate expectations can constitute a bar to regulations that further a non-investment related interest and adversely affect the expectations an investor had when making its investments. Finally, proportionality reasoning has played a role in the context of applying so-called non-precluded measures clauses.<sup>47</sup>

### A. Proportionality Analysis and the Concept of Indirect Expropriation

International takings law is one field where the tension between investment protection and conflicting rights and interests crystallizes. Virtually all investment treaties contain a prohibition on expropriations without compensation. A typical provision is contained, for example, in the BIT between Germany and China that provides:

Investments by investors of either Contracting Party shall not directly or indirectly be expropriated, nationalized or subjected to any other measure the effects of which would be tantamount to expropriation or nationalization in the territory of the other Contracting Party (hereinafter referred to as expropriation) except for the public benefit and against compensation.<sup>48</sup>

Expropriation is not necessarily confined to direct expropriations or nationalizations that involve the transfer of title from the foreign investor to the state or a third party. Depending on the treaty provision or other controlling standards (such as customary international law), it may also cover so-called indirect, creeping, or *de facto* expropriations, involving state measures that do not interfere with the owner's title, but negatively affect the property's substance or void the owner's control over it.<sup>49</sup> Thus one NAFTA tribunal opined that the concept of expropriation:

... includes not only open, deliberate and acknowledged takings of property, such as outright seizure or formal or obligatory transfer of title in favour of the host State, but also covert or incidental interference with the use of property which

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<sup>47</sup> On proportionality analysis in investor-state arbitration see also A Stone Sweet, 'Investor-State Arbitration: Proportionality's New Frontier' (2010) 4(1) *Law & Ethics of Human Rights* 47, available at <<http://www.bepress.com/lehr/vol4/iss1/art4>>.

<sup>48</sup> Agreement between the People's Republic of China and the Federal Republic of Germany on the Encouragement and Reciprocal Protection of Investments, signed 1 December 2003, entry into force 11 November 2005, Art 4(2).

<sup>49</sup> On the concept of indirect expropriation, see eg M Perkams, 'The Concept of Indirect Expropriation in Comparative Public Law—Searching for Light in the Dark', Chapter 4 below, 107; BH Weston, "Constructive Takings" under International Law: A Modest Foray into the Problem of "Creeping Expropriation" (1975) 16 *Va JIL* 103; R Higgins, 'The Taking of Property by the State: Recent Developments in International Law' (1982) 176 *Recueil des Cours* 259, 322 *et seq*; R Dolzer, 'Indirect Expropriation of Alien Property' (1986) 1 *ICSID Rev-FILJ* 41; TW Wälde and A Kolo, 'Environmental Regulation, Investment Protection and "Regulatory Taking" in International Law' (2001) 50 *ICLQ* 811; Fortier and Drymer (n 6 above) 293; A Newcombe, 'The Boundaries of Regulatory Expropriation' (2005) 20 *ICSID Rev-FILJ* 1.

has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host State.<sup>50</sup>

Classical customary international law and treaty jurisprudence typically hold that covered direct and indirect expropriations are only lawful under international investment treaties if they fulfil a public purpose, are implemented in a non-discriminatory manner, and observe due process of law. Finally, and most importantly, both direct and indirect expropriations regularly require compensation.<sup>51</sup>

Indirect expropriation can also occur based on regulatory acts of the host state. In arbitral jurisprudence, tribunals vary in basic approaches to the issue of how to distinguish between compensable expropriation and non-compensable regulation of property.<sup>52</sup> Some tribunals solely look at the effects the host state's measure has, thus finding a compensable indirect expropriation because the impact of the measure reaches a certain intensity, owing either to the permanent interference with fundamental components of the right to property,<sup>53</sup> or to the substantial diminution in or destruction of the value of the property in question.<sup>54</sup>

The majority of the tribunals, however, take into account the purpose of a state's measure and adopt the so-called police power doctrine in deciding whether a general measure entitles an investor to compensation under the concept of indirect expropriation.<sup>55</sup> The police power doctrine recognizes that a state has the power

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<sup>50</sup> *Metalclad Corp v United Mexican States* ICSID Case No ARB(AF)/97/1 (NAFTA), Award, 30 August 2000, para 103.

<sup>51</sup> For the question of whether the level of compensation differs for indirect expropriation, see Y Nouvel, 'L'indemnisation d'une expropriation indirecte' (2003) 5 Int L Forum 198; TW Merrill, 'Incomplete Compensation for Takings' (2002–03) 11 NYU ELJ 110. cf also WM Reisman and RD Sloane, 'Indirect Expropriation and Its Valuation in the BIT Generation' (2003) 74 BYBIL 115.

<sup>52</sup> See R Dolzer, *Eigentum, Enteignung und Entschädigung im geltenden Völkerrecht* (1985) 186 *et seq*; R Dolzer, 'Indirect Expropriation: New Developments?' (2002–03) 11 NYU ELJ 64, with further references.

<sup>53</sup> See *Starrett Housing Corp v Iran* Award, 19 December 1983, 4 Iran-US CTR 122, 154; *Tippetts, Abbott, McCarthy, Stratton v TAMS-AFFA and ors* Award, 29 June 1984, 6 Iran-US CTR 219, 225 *et seq.*; on the jurisprudence of the Iran-United States Claims Tribunal on expropriations, see G Aldrich, 'What Constitutes a Compensable Taking of Property? The Decisions of the Iran-United States Claims Tribunal' (1994) 88 AJIL 585.

<sup>54</sup> *Phelps Dodge Corp v Iran* Award, 19 March 1986, 10 Iran-US CTR 121, 130; see also SR Swanson, 'Iran-U.S. Claims Tribunal: A Policy Analysis of the Expropriation Cases' (1986) 18 CWR JIL 307, 325 *et seq*; Weston (n 49 above) 119 *et seq.*

<sup>55</sup> M Brunetti, 'Indirect Expropriation in International Law' (2003) 5 Int L Forum 150; Dolzer, 'Indirect Expropriation: New Developments?' (n 52 above) 79 *et seq*; R Dolzer and F Bloch, 'Indirect Expropriation: Conceptual Realignment?' (2003) 5 Int L Forum 155, 158 *et seq*; AS Weiner, 'Indirect Expropriation: The Need for a Taxonomy of "Legitimate" Regulatory Purposes' (2003) 5 Int L Forum 166; S Ratner, 'Regulatory Takings in Institutional Context: Beyond the Fear of Fragmented International Law' (2008) 102 AJIL 475; *Sea-Land Service Inc v Iran* Award, 20 June 1984, 6 Iran-US CTR 149, 165; *Sedco Inc v NIOC and Iran* Award, 24 October 1985, 9 Iran-US CTR 248, 275 *et seq*; *Emanuel Too v Greater Modesto Insurance Associates, et al* Award, 29 December 1989, 23 Iran-US CTR 378, 387 *et seq.*

to restrict private property rights without compensation in pursuance of a legitimate purpose. Under this approach, it is not sufficient to determine the effect of a state measure; instead, the measure's effect has to be balanced in relation to the object and purpose of the interference.

Even though most investment treaties do not explicitly contain exceptions to the protection of property,<sup>56</sup> tribunals acknowledge that host states have the power to restrict private property rights without compensation in pursuance of a legitimate purpose, so long as the measure taken with this purpose is reasonably balanced in relation to the regulation's effect on the investment. Thus, the tribunal in *Tecmed v Mexico* held that a police power exception formed part of the international law of expropriation: 'The principle that the State's exercise of its sovereign powers within the framework of its police power may cause economic damage to those subject to its powers as administrator without entitling them to any compensation whatsoever is undisputable.'<sup>57</sup> Similarly, the tribunal in *Methanex v United States* stressed that:

... as a matter of general international law, a non-discriminatory regulation for a public purpose, which is enacted in accordance with due process and which affects, inter alios, a foreign investor or investment is not deemed expropriatory and compensable unless specific commitments had been given by the regulating government to the then putative foreign investor contemplating investment that the government would refrain from such regulation.<sup>58</sup>

How the balancing itself is to be done, however, is not always explained in depth by arbitral tribunals. Yet, the approach of the tribunal in *Tecmed v Mexico* illustrates well the use of a proportionality analysis to manage tensions between investment protection and competing public policies. In the case at hand, Mexican authorities had not renewed the temporary operating licence for a waste landfill

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<sup>56</sup> Security exceptions or similar non-precluded measures provisions, such as those often included in US bilateral investment treaties, raise special issues and are not addressed in this chapter. See eg Art 10(1) of the Treaty Between the United States of America and the Arab Republic of Egypt Concerning the Reciprocal Encouragement and Protection of Investments, signed 11 March 1986, entry into force 27 June 1992, stating: 'This Treaty shall not preclude the application by either Party or any subdivision thereof of any and all measures necessary for the maintenance of public order and morals, the fulfillment of its existing international obligations, the protection of its own security interests, or such measures deemed appropriate by the Parties to fulfill future international obligations.' For one view of these clauses, see JE Alvarez and K Khamsi, 'The Argentine Crisis and Foreign Investors: A Glimpse into the Heart of the Investment Regime' (2008/2009) 1 Yearbook of International Investment Law and Policy 379. For a different view see W Burke-White and A von Staden, 'Investment Protection in Extraordinary Times: The Interpretation and Application of Non-Precluded Measures Provisions in Bilateral Investment Treaties' (2008) 48 Va JIL 307.

<sup>57</sup> *Tecnicas Medioambientales Tecmed SA v United Mexican States*, ICSID Case No ARB(AF)/00/2, Award, 29 May 2003, para 119.

<sup>58</sup> *Methanex Corp v US UNCITRAL/NAFTA*, Final Award, 3 August 2005, Part IV, Chapter D, para 7. Similarly, *International Thunderbird Gaming Corp v United Mexican States UNCITRAL/NAFTA*, Arbitral Award, 26 January 2006, para 127; *Saluka v Czech Republic* (n 46 above) paras 254–262; *LG&E Energy Corp, LG&E Capital Corp, LG&E International Inc v Argentine Republic* ICSID Case No ARB/02/1, Decision on Liability, 3 October 2006, paras 194–197; *Marvin Roy Feldman Karpa v United Mexican States* ICSID Case No ARB(AF)/99/1 (NAFTA), Award, 16 December 2002, paras 103–106.

that was essential to the business of the Mexican subsidiary of a Spanish investor. For the tribunal this constituted a compensable indirect expropriation. In its argumentation concerning the distinction between indirect expropriation and regulation, the tribunal drew on the jurisprudence on Article 1 of the First Additional Protocol to the ECHR, and weighed the conflicting interests using a proportionality test familiar from the Strasbourg Court jurisprudence.

While the agency had justified non-renewal of the landfill's licence on the basis of the operator's lack of reliability, *inter alia*, owing to its having processed biological and other toxic waste in violation of the operating licence and having exceeded the landfill's capacity,<sup>59</sup> the tribunal concluded that political considerations had been decisive.<sup>60</sup> It pointed out that only after massive protests by the local population had occurred in late 1997, did the agency resolve to accelerate the relocation of the landfill by refusing to renew the licence.<sup>61</sup> Although the investor had already agreed to relocate the landfill, its request to renew the operating licence for another five months until the relocation could take place was refused. Moreover, the agency ordered the investor to cease its activities immediately.<sup>62</sup>

In applying the concept of indirect expropriation to the facts at hand, the tribunal followed a two-step analysis. In a first step, it determined whether the state's measure itself was sufficiently intense in order for a non-compensable regulation to turn into a compensable indirect expropriation. This, the tribunal considered, depended on two factors: a temporal and a substantive one. First, the interference with the property interest in question must not be of a transitional nature only; secondly, the interference must lead to a complete destruction of the property's value. Since the landfill facility could not be used for a different purpose, and could not be sold because of the existing contamination,<sup>63</sup> the effect of the non-renewal of the licence potentially amounted to an expropriation.

The tribunal, however, did not conclude its analysis there. Instead, in a second step, it considered the effects of the non-renewal of the operating licence only as one factor among others in distinguishing between regulation and indirect expropriation. The reason for this approach, according to the tribunal, is that bilateral investment treaties in principle do not exclude a state's regulatory power, even if the treaty text did not explicitly provide for the continuous existence of such power.<sup>64</sup> Consequently, the tribunal posited that the BIT requires only that the effects of a specific state measure on private property have to be proportional to the exercise of the state's police power. In essence, the tribunal therefore considered property to be inherently bound and restricted by the police power of the state even though the wording of the Treaty did not explicitly mention a police power exception.

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<sup>59</sup> *Tecmed v Mexico* (n 57 above) 99 *et seq.*      <sup>60</sup> *ibid* paras 127 *et seq.*

<sup>61</sup> *ibid* paras 106 *et seq.*      <sup>62</sup> *ibid* paras 45 and 110 *et seq.*      <sup>63</sup> *ibid* para 117.

<sup>64</sup> *ibid* paras 118 *et seq.*

Following the doctrinal structure of fundamental rights reasoning, the tribunal then engaged in a comprehensive proportionality test that weighed and balanced the competing interests in order to determine when legitimate regulation flipped over into indirect expropriation. In doing so, the tribunal essentially aimed at achieving ‘*Konkordanz*’ of the various rights and interests affected.<sup>65</sup> From this perspective, a compensable indirect expropriation occurs only when state measures lead to disproportional restrictions of the right to property. Thus, the tribunal stated:

... the 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. Although the analysis starts at the due deference owing to the State when defining the issues that affect its public policy or the interests of society as a whole, as well as the actions that will be implemented to protect such values, such situation does not prevent the Arbitral Tribunal, without thereby questioning such due deference, from examining the actions of the State in light of Article 5(1) of the Agreement to determine whether such measures are reasonable with respect to their goals, the deprivation of economic rights and the legitimate expectations of who suffered such deprivation. 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. To value such charge or weight, it is very important to measure the size of the ownership deprivation caused by the actions of the State and whether such deprivation was compensated or not.<sup>66</sup>

The concrete aspects the tribunal considered in its balancing approach were the legitimate expectations of the investor, the importance of the regulatory interest pursued by the host state, the weight and the effect of the restriction, and other circumstances concerning the investor’s position (such as the prior violations of the terms of the operating licence by the company).<sup>67</sup> Apart from that, the tribunal, in assessing proportionality, also accorded importance to the question of whether an investor has been especially and unequally affected by the adoption of

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<sup>65</sup> The term ‘*Konkordanz*’ or ‘*praktische Konkordanz*’ was coined by the German constitutional law scholar Konrad Hesse and refers to a concept or method of reconciliation and balancing of competing fundamental rights. In a case where two fundamental rights collide, ‘*Konkordanz*’ requires that both rights be reconciled without giving up either one of them. What this concept primarily excludes is perceiving one of the fundamental rights as superior to any other such right. Instead both rights have to be reconciled in a differentiated manner, a task that is achieved in the fundamental rights context by balancing the different rights and interests under a comprehensive proportionality methodology while aiming at a solution that gives both rights effective protection to the possible extent. See K Hesse, *Grundzüge des Verfassungsrechts der Bundesrepublik Deutschland* (20th edn, 1995) para 72. The concept has been recognized as a governing principle by the German Constitutional Court, see BVerfGE 41, 29; BVerfGE 77, 240; BVerfGE 81, 298; BVerfGE 83, 130; BVerfGE 108, 282. The concept can also be found in the constitutional jurisprudence of the French *Conseil Constitutionnel*, CC *décision* no 94-352 DC, 18 January 1995, available at <<http://www.conseil-constitutionnel.fr/decision/1994/94352dc.htm>>.

<sup>66</sup> *Tecmed v Mexico* (n 57 above) para 122.

<sup>67</sup> *ibid* paras 149 *et seq.*

a measure.<sup>68</sup> In conclusion, the tribunal held that the non-renewal of the licence restricted the claimant's property rights disproportionately and therefore constituted an indirect expropriation. The tribunal placed particular emphasis on the fact that the degree of the operating company's breaches was marginal and that the breaches could not be invoked to justify the refusal to renew the licence.

In addition, the tribunal also fleshed out its general approach to proportionality reasoning by enumerating certain restrictions on the right to property that it considered likely to be proportional, such as police measures taken to eliminate threats to public safety, ie measures addressed either to the person directly threatening public safety or, in case of an emergency, even against a third party that does not itself constitute a threat to public safety.<sup>69</sup> Interferences with the right to property which are aimed at the prevention of danger are therefore often in conformity with international law and do not necessarily give rise to a claim for compensation.

A similar proportionality analysis was also adopted by the tribunal in *LG&E v Argentina*, a case that concerned the emergency measures Argentina took in the context of its economic crisis in 2001–02. These measures included the pesification of dollar-denominated debts and claims, and affected tariff guarantees that were given to foreign investors in the gas and electricity sectors. LG&E brought a claim under the United States–Argentina BIT and argued that the effect of these measures significantly affected the value of its shareholding in an Argentine subsidiary that operated in the gas sector, thus constituting an indirect expropriation.<sup>70</sup>

However, the tribunal denied a finding of indirect expropriation partly because it required a high threshold for interferences with investments in order for them to constitute indirect expropriations. In the tribunal's view, indirect expropriation in the case of shareholder claims presupposed that 'governmental measures have "effectively neutralize[d] the benefit of property of the foreign owner". Ownership or enjoyment can be said to be "neutralized" where a party is no longer in control of the investment, or where it cannot direct the day-to-day operations of the investment.'<sup>71</sup> In addition, the tribunal emphasized that interferences that amount to indirect expropriation ordinarily are permanent measures.<sup>72</sup>

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<sup>68</sup> *ibid* para 122. This idea is conveyed in an important strain of takings jurisprudence in Germany that relies on whether property owners had to suffer a special sacrifice to the benefit of the general public ('*Sonderopfer*'). On this, see Wälde and Kolo (n 49 above) 845 *et seq*.

<sup>69</sup> *Tecmed v Mexico* (n 57 above) para 136.

<sup>70</sup> See *LG&E Energy Corp, LG&E Capital Corp, LG&E International Inc v Argentine Republic* ICSID Case No ARB/02/1, Decision on Liability, 3 October 2006, para 177. See on the decision, also in comparison to the earlier *CMS v Argentina* Award, S Schill, 'International Investment Law and the Host State's Power to Handle Economic Crises' (2007) 24 *Jl Arb* 265.

<sup>71</sup> *LG&E v Argentina* (n 70 above) para 188, citing *CME Czech Republic BV v Czech Republic* UNCITRAL, Partial Award, 13 September 2001, para 604 and *Pope & Talbot Inc v Government of Canada* UNCITRAL/NAFTA, Interim Award, 26 June 2000, para 100.

<sup>72</sup> *LG&E v Argentina* (n 70 above) para 193. See also *ibid* para 191 (citing *Pope & Talbot Inc v Government of Canada* UNCITRAL/NAFTA, Interim Award, 26 June 2000, paras 101 *et seq*),

In addition, the tribunal endorsed the approach taken by the tribunal in *Tecmed v Mexico* and incorporated that tribunal's reasoning on a proportionality or balancing test for distinguishing between legitimate non-compensable regulation and compensable indirect expropriation. The tribunal in *LG&E* noted:

The question remains as to whether one should only take into account the effects produced by the measure or if one should consider also the context within which a measure was adopted and the host State's purpose. It is this Tribunal's opinion that there must be a balance in the analysis both of the causes and the effects of a measure in order that one may qualify a measure as being of an expropriatory nature. It is important not to confound the State's right to adopt policies with its power to take an expropriatory measure. 'This determination is important because it is one of the main elements to distinguish, from the perspective of an international tribunal between a regulatory measure, which is an ordinary expression of the exercise of the State's police power that entails a decrease in assets or rights, and a *de facto* expropriation that deprives those assets and rights of any real substance.'<sup>73</sup>

The tribunal in *LG&E* thus suggested that international investment treaties ordinarily do not exclude the host state's power to regulate in the public interest. Instead, it emphasizes that the 'State has the right to adopt measures having a social or general welfare purpose'.<sup>74</sup> This position is in line with the view of several international courts and tribunals, ie that a state is, in general, not internationally liable for bona fide regulation.<sup>75</sup> Yet, at the same time, the tribunal in *LG&E* suggests that in exceptional cases even generally applicable regulation in the public interest may require compensation if it is 'obviously disproportionate'.<sup>76</sup>

A similar approach is also reflected in recent treaty practice, in particular recent US agreements, which include an interpretation of the concept of indirect expropriation that states: 'Except in rare circumstances, nondiscriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations.'<sup>77</sup> This essentially incorporates a proportionality test

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stating that: 'Interference with the investment's ability to carry on its business is not satisfied where the investment continues to operate, even if profits are diminished. The impact must be substantial in order that compensation may be claimed for the expropriation.'

<sup>73</sup> *LG&E v Argentina* (n 70 above) para 194, quoting from *Tecmed v Mexico* (n 57 above) para 115.

<sup>74</sup> *LG&E v Argentina* (n 70 above) para 195.

<sup>75</sup> *ibid* para 196, citing American Law Institute, *Restatement (Third) of the Foreign Relations Law of the United States* (1987) Vol I, Section 712, Commentary g, *Too v US* (n 55 above) 387 *et seq*, and *The Oscar Chinn Case (UK v Belgium)* Judgment, 12 December 1934, PCIJ Series A/B, No 63. Similarly, *Sea-Land Service v Iran* (n 55 above) 165; *Sedco Inc v Iran* (n 55 above) 275 *et seq*; *Methanex v US* (n 58 above) Part IV Chapter D, para 7; *International Thunderbird Gaming v Mexico* (n 58 above) paras 123 *et seq*; *Saluka v Czech Republic* (n 46 above) paras 253 *et seq*.

<sup>76</sup> *LG&E v Argentina* (n 70 above) para 195, citing *Tecmed v Mexico* (n 57 above) para 122.

<sup>77</sup> See eg Art 15.6 of the United States–Singapore Free Trade Agreement, signed 15 January 2003, entry into force 1 January 2004, in connection with an exchange of letters on the scope of the concept of indirect expropriation, available at <<http://www.ustr.gov/trade-agreements/freetrade-agreements/singapore-fta/final-text>>.

into the application of the concept of indirect expropriation and thereby helps in balancing investment protection and competing public policy purposes.

## **B. Proportionality Analysis and Fair and Equitable Treatment**

Proportionality analysis can also apply in some contexts and with regard to some sub-elements of the fair and equitable treatment standard. This standard has been interpreted by different tribunals as encompassing stability and predictability of the legal framework, consistency in the host state's decision-making, the protection of investor confidence or 'legitimate expectations', procedural due process and the prohibition of denial of justice, the requirement of transparency, and the concepts of reasonableness and proportionality.<sup>78</sup> Actually applying many of these general propositions often entails weighing competing interests, as well as establishing a standard of review, burdens of proof, and appropriate degrees of deference.

For example, the protection of the investor's legitimate expectations does not make the domestic legal framework unchangeable or subject every change in the regulatory framework to a compensation requirement. Rather a balancing test is sometimes needed in order to apply this, and potentially other, aspects of fair and equitable treatment.<sup>79</sup> Thus, 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'.<sup>80</sup> Instead, the tribunal set out to balance the investor's legitimate expectations and the host state's interests through 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

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<sup>78</sup> See S Schill, 'Fair and Equitable Treatment, the Rule of Law, and Comparative Public Law', Chapter 5 below, 151, 159 *et seq.*

<sup>79</sup> The main difference between the concept of indirect expropriation and the protection of legitimate expectations under fair and equitable treatment is that indirect expropriation requires interference with a property interest or entitlement, whereas the protection of legitimate expectations under fair and equitable treatment is broader and can encompass the expectation in the continuous existence and operation of a certain regulatory or legislative framework. Balancing tests of different sorts are also beginning to be used in the jurisprudence of investment tribunals on other issues, including in the interpretation of umbrella clauses.

<sup>80</sup> *Saluka v Czech Republic* (n 46 above) para 304.

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 non-discrimination. In particular, any differential treatment of a foreign investor must not be based on unreasonable distinctions and demands, and must be justified by showing that it bears a reasonable relationship to rational policies not motivated by a preference for other investments over the foreign-owned investment.<sup>81</sup>

The general approach of the tribunal in the *Saluka* case has also been endorsed by various other tribunals.<sup>82</sup> More broadly, however, arbitral tribunals increasingly link fair and equitable treatment to the concepts of reasonableness and proportionality, controlling the extent to which interferences of host states with foreign investments are permitted. The assessment by the tribunal in *Pope & Talbot v Canada* of the reasonableness of the conduct of an administrative agency,<sup>83</sup> and the comments by the tribunal in *Eureko v Poland* concerning the adequacy of the reasons why the expectations of the investor could not be met, can be seen as importing a general concept of reasonableness into specific interpretations and applications of the fair and equitable treatment standard.<sup>84</sup>

Proportionality-related analysis likewise can potentially play a role when arbitral tribunals scrutinize whether the exercise of administrative discretion conforms to fair and equitable treatment. The case of *Middle East Cement Shipping and Handling v Egypt*<sup>85</sup> 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. A key question was whether the procedural implementation of the auction was valid, in particular whether sufficient notice of the seizure was given.<sup>86</sup> Arguably in

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<sup>81</sup> *ibid* paras 305 *et seq.*

<sup>82</sup> See eg *BG Group plc v The Republic of Argentina* UNCITRAL, Final Award, 24 December 2007, para 298: 'The duties of the host State must be examined in the light of the legal and business framework as represented to the investor at the time that it decides to invest. This does not imply a freezing of the legal system, as suggested by Argentina. Rather, in order to adapt to changing economic, political and legal circumstances the State's regulatory power still remains in place. As previously held by tribunals addressing similar considerations, "... the host State's legitimate right subsequently to regulate domestic matters in the public interest must be taken into consideration as well"' (citing *Saluka v Czech Republic* (n 46 above) para 304). A comparable framing, but in relation to expropriation under NAFTA, is that in *Feldman v Mexico* (n 58 above) para 112: 'not all government regulatory activity that makes it difficult or impossible for an investor to carry out a particular business, change in the law or change in the application of existing laws that makes it uneconomical to continue a particular business, is an expropriation... Governments, in their exercise of regulatory power, frequently change their laws and regulations in response to changing economic circumstances or changing political, economic or social considerations. Those changes may well make certain activities less profitable or even uneconomic to continue.'

<sup>83</sup> See *Pope & Talbot v Canada* (n 72 above) paras 123, 125, 128, 155; see also *MTD v Chile* (n 46 above) para 109, with a reference to an expert opinion by Steven Schwebel.

<sup>84</sup> See *Eureko BV v Republic of Poland* Partial Award, 19 August 2005, paras 232 *et seq.*

<sup>85</sup> *Middle East Cement Shipping and Handling Co SA v Arab Republic of Egypt* ICSID Case No ARB/99/6, Award, 12 April 2002.

<sup>86</sup> The issue turned on the question of whether the seizure breached the fair and equitable treatment standard and the due process requirement in the provision prohibiting direct and indirect expropriations without compensation in the Egyptian-Greek BIT.

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'.<sup>87</sup>

This reasoning implies, without formulating it explicitly, a proportionality-type analysis, weighing the importance of investment protection, the legitimate government interest pursued, and the fact that less restrictive but equally effective ways were available to put the claimant on notice of the impending seizure of his ship.

### C. Proportionality Analysis and Non-Precluded Measures Clauses

Proportionality reasoning has also played a role for some tribunals in determining whether the Argentine emergency measures in reaction to its economic crisis in 2001–02 have met the test established by a so-called non-precluded measures clause, namely Article XI of the United States–Argentina BIT which provides: 'This Treaty shall not preclude the application by either Party of measures necessary for the maintenance of public order, the fulfilment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests.'<sup>88</sup>

The first few tribunals to interpret this provision in cases relating to the crisis did not use proportionality reasoning. Instead they focused heavily on the customary international law concept of necessity and Article 25 of the ILC Articles on State Responsibility. Some adopted a strict test of whether Argentina's emergency legislation constituted the 'only means' to react to the economic crisis.<sup>89</sup> Other tribunals, however, approached this provision quite differently. In particular, the tribunal in *Continental Casualty v Argentina* used a form of proportionality

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<sup>87</sup> *Middle East Cement Shipping v Egypt* (n 85 above) para 143.

<sup>88</sup> Art XI of the Treaty between the United States and the Argentine Republic Concerning the Reciprocal Encouragement and Protection of Investment, signed 11 November 1991, entered into force 20 October 1994, 31 ILM 124 (1992).

<sup>89</sup> On the arbitral case law concerning the measures adopted by Argentina in reaction to its economic crisis in 2001–02, in particular the conceptualizations of the concept of necessity under customary international law and the interpretation of Art XI of the US–Argentina BIT, see J Kurtz, 'Adjudging the Exceptional at International Investment Law: Security, Public Order and Financial Crisis' (2010) 59 ICLQ 325. See also C Binder and A Reinisch, 'Economic Emergency Powers: a Comparative Law Perspective', Chapter 16 below, 503.

analysis in interpreting Article XI of the United States-Argentina BIT.<sup>90</sup> The claim concerned the assertion that Argentina breached its investment treaty obligations when imposing restrictions on withdrawals and transfers from bank accounts (so-called *corralito*), pesifying US dollar deposits, pesifying and delaying payments on government debt, and restructuring debt—all measures which allegedly affected the cash accounts, certificates of deposit, and various government bonds and debt held by the claimant's Argentine subsidiary.<sup>91</sup> Argentina, by contrast, argued that the measures were adopted in reaction to its severe financial crisis and were covered by Article XI of the United States-Argentina BIT as being 'necessary for the maintenance of public order'.<sup>92</sup>

The tribunal in *Continental Casualty* largely accepted Argentina's reliance on Article XI. Unlike other tribunals, it employed proportionality reasoning in close reliance on WTO Appellate Body jurisprudence on the interpretation of Article XX of GATT, in determining whether the measures adopted were *necessary* to maintain public order.<sup>93</sup> After finding that 'actions properly necessary... to preserve or to restore civil peace and the normal life of society... [and] to prevent and repress illegal actions and disturbances that may infringe such civil peace and potentially threaten the legal order, even when due to significant economic and social difficulties... do fall within the application under Art. XI',<sup>94</sup> and granting 'a significant margin of appreciation for the State applying the particular measure',<sup>95</sup> the tribunal considered that, in determining what measures were necessary under Article XI, parallels should not be drawn with the 'only means' test some tribunals had regarded as relevant from customary international law, but with the test for necessity in Article XX of GATT.<sup>96</sup>

This test, the tribunal in *Continental Casualty* observed,<sup>97</sup> was defined by the Appellate Body in *Korea-Beef* as follows:

... the reach of the word 'necessary' is not limited to that which is 'indispensable' or 'of absolute necessity' or 'inevitable'... As used in Article XX(d), the term 'necessary' refers, in our view, to a range of degrees of necessity. At one end of this continuum lies 'necessary' understood as 'indispensable'; at the other end, is 'necessary' taken to mean as 'making a contribution to.' We consider that a 'necessary' measure

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<sup>90</sup> *Continental Casualty Co v Argentine Republic* ICSID Case No ARB/03/9, Award, 5 September 2008.

<sup>91</sup> *ibid* paras 17–19. <sup>92</sup> *ibid* para 160.

<sup>93</sup> This close reliance on WTO jurisprudence may well be linked to the fact that Giorgio Sacerdoti, who has served as a member of the WTO Appellate Body, was the President of the Tribunal.

<sup>94</sup> *Continental v Argentina* (n 90 above) para 174.

<sup>95</sup> *ibid* para 181, relying on *Jahn and ors v Germany* Judgment, 30 June 2005, ECHR 2005-VI.

<sup>96</sup> *Continental v Argentina* (n 90 above) para 192, arguing that this parallel was justified because 'the text of Article XI derives from the parallel model clause of the U.S. FCN treaties and these treaties in turn reflect the formulation of Article XX of GATT 1947'.

<sup>97</sup> *ibid* paras 193–195.

is, in this continuum, located significantly closer to the pole of 'indispensable' than to the opposite pole of simply 'making a contribution to'.<sup>98</sup>

The tribunal then continued, by quoting the Panel Report in *Brazil-Tyres*, that:

The necessity of a measure should be determined through 'a process of weighing and balancing of factors' which usually includes the assessment of the following three factors: the relative importance of interests or values furthered by the challenged measures, the contribution of the measure to the realization of the ends pursued by it and the restrictive impact of the measure on international commerce.<sup>99</sup>

In line with WTO jurisprudence, the necessity of a measure under Article XI of the United States-Argentina BIT, would not be established if 'another treaty consistent, or less inconsistent alternative measure, which the member State concerned could reasonably be expected to employ is available'.<sup>100</sup> As stated by the Appellate Body:

An alternative measure may be found not to be 'reasonable available,' however, where it is merely theoretical in nature, for instance, where the responding Member is not capable of taking it, or where the measure imposes an undue burden on that Member, such as prohibitive costs or substantial technical difficulties. Moreover, a 'reasonable available' alternative measure must be a measure that would preserve for the responding Member its right to achieve its desired level of protection with respect to the objective pursued under paragraph (a) of Article XIV.<sup>101</sup>

In applying the standard thus set out, the tribunal in *Continental Casualty* then assessed first whether Argentina's measures 'contributed materially to the realization of their legitimate aims under Art. XI of the BIT, namely the protection of the essential security interests of Argentina in the economic and social crisis it was facing'.<sup>102</sup> As regards the suitability of the measures to contribute to a legitimate aim, the tribunal concluded that all measures 'were in part inevitable, or unavoidable, in part indispensable and in any case material or decisive in order to react positively to the crisis . . . In the Tribunal's view, there was undoubtedly "a genuine relationship of end and means in this respect"'.<sup>103</sup> Secondly, the tribunal engaged

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<sup>98</sup> *Korea—Measures Affecting Imports of Fresh, Chilled and Frozen Beef*, WT/DS161/AB/R, Report of the Appellate Body, 11 December 2000, para 161.

<sup>99</sup> *Continental v Argentina* (n 90 above) para 194, quoting *Brazil—Measures Affecting the Imports of Retreaded Tyres*, WT/DS332/R, Report of the Panel, 12 June 2007, para 7.104; *Korea—Beef* (n 98 above) para 164; *European Communities—Measures Affecting Asbestos and Asbestos-Containing Products* WT/DS135/AB/R, Report of the Appellate Body, 12 March 2001, para 172; *United States—Measures Affecting the Cross-Border Supply of Gambling and Betting Services* WT/DS285/AB/R, Report of the Appellate Body, 7 April 2005, para 306; *Dominican Republic—Measures Affecting the Importation and Internal Sale of Cigarettes* WT/DS302/AB/R, Report of the Appellate Body, 25 April 2005, para 70.

<sup>100</sup> *Continental v Argentina* (n 90 above) para 195.

<sup>101</sup> *US—Gambling* (n 99 above) para 308, quoted in *Continental v Argentina* (n 90 above) para 195.

<sup>102</sup> *Continental v Argentina* (n 90 above) para 196.

<sup>103</sup> *ibid* para 197, quoting *Brazil—Measures Affecting the Imports of Retreaded Tyres* WT/DS332/AB/R, Report of the Appellate Body, 3 December 2007, para 145.

in an ‘analysis of whether Argentina had reasonably available alternatives, less in conflict or more compliant with its international obligations, “while providing an equivalent contribution to the achievement of the objective pursued,” to the Measures challenged by Continental as inconsistent with the BIT’,<sup>104</sup> This reflects the second step of proportionality reasoning outlined above.<sup>105</sup> At the same time, however, the tribunal emphasized that some deference would be accorded to the host state: ‘the Tribunal is not called upon to make any political or economic judgment on Argentina’s policies and of the Measures adopted to pursue them.’<sup>106</sup>

Subsequently, the tribunal found that Argentina had no reasonable alternatives to the restrictions of transfers and withdrawals of accounts, to the devaluation of its currency and the abolition of the peg of the Peso to the US dollar, to the pesification of dollar-denominated contracts and debt, and also no real alternative to the restructuring of most of the government bonds owned by claimant’s subsidiary.<sup>107</sup> As regards the restructuring of certain government bonds, however, notably Treasury Bills, which were only restructured in December 2004, the tribunal did not accept that Argentina’s measures met the necessity test, notably because of:

- (a) the late date in which the swap was offered, when Argentina’s financial conditions were evolving towards normality;
- (b) the reduced percentage of the original value of the debt that Argentina unilaterally offered to recognize;
- (c) the condition that any other rights would be waived, which entailed also waiving the protection of the BIT.<sup>108</sup>

With respect to these bonds, the tribunal therefore proceeded in assessing whether the restructuring breached provisions of the United States-Argentina BIT and found a violation of fair and equitable treatment.<sup>109</sup>

The decision in *Continental Casualty v Argentina* illustrates how proportionality reasoning can effectively migrate from one international legal regime to another, here from WTO law to investment treaty arbitration. It demonstrates how this type of reasoning allows arbitral tribunals to review whether host states have struck a reasonable balance between the protection of foreign investment and the furtherance of some non-investment-related interest. Combining this with the margin of appreciation-doctrine, as the tribunal in effect did in *Continental Casualty*, is one way to mitigate concerns that investment treaties unilaterally favour investors over the protection of important public interests.<sup>110</sup> At the same time, proportionality analysis leaves sufficient power with arbitral tribunals to

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<sup>104</sup> *Continental v Argentina* (n 90 above) para 198, quoting *Brazil—Tyres* (n 103 above) para 156.

<sup>105</sup> See Part III.B above. <sup>106</sup> *Continental v Argentina* (n 90 above) para 199.

<sup>107</sup> *ibid* paras 201–219. <sup>108</sup> See *ibid* paras 220–222, quotation at para 221.

<sup>109</sup> See *ibid* paras 246–266.

<sup>110</sup> On the margin of appreciation as a standard of review, see also W Burke-White and A von Staden, ‘The Need for Public Law Standards of Review in Investor-State Arbitrations’, Chapter 22 below, 689. For critique of *Continental v Argentina*, see J Alvarez and T Brink, ‘Revisiting the

remediate those measures that are not suitable and not without reasonably less restrictive alternatives for achieving a legitimate public purpose.

## **V. Conclusion: Proportionality Analysis and Reasoning in Investment Arbitration**

Proportionality analysis is increasingly applied by investment tribunals, in ways that have some resemblances to those in many domestic legal orders and those in other international dispute settlement systems, including in the European Union, under the ECHR or in the WTO. This has been particularly evident in cases concerned with the determination of whether host state measures constitute an indirect expropriation or a violation of some aspects of fair and equitable treatment. Proportionality has been applied also by tribunals in determining whether departures from investment treaty obligations to protect specified vital interests of the host state are permissible. In all these situations, competing interests need to be weighed and balances struck between private property-type interests on the one hand and other public interests on the other. Reviewing whether the balance struck by the host state is proper from the point of view of investment protection can be done in part through proportionality analysis.

Proportionality analysis, however, is open to the criticisms that it confers power on arbitrators to take policy-driven decisions about the proper balance between conflicting rights and interests, and that it encourages a focus on principles above rules. This criticism may be less problematic in the domestic context as the legislature there has power to reverse court decisions on administrative and legislative standards, at least with regard to future cases. Yet, in the investment treaty context, the revision of BITs is a slow process requiring the consent of both contracting state parties. Furthermore, most investment treaties do not provide for an institutional procedure that can be triggered in order to adapt the interpretation of investment treaties in response to interpretations by investment tribunals, for example along the lines of the NAFTA Free Trade Commission, an organ through which the NAFTA parties can jointly issue authoritative interpretations of the rules and standards applicable to investor-state disputes.<sup>111</sup> While the application

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Necessity Defense: *Continental Casualty v Argentina*' IILJ Working Paper 2010/3, available at <<http://www.iilj.org/publications/2010-3.Alvarez-Brink.asp>>.

<sup>111</sup> See NAFTA, Art 1131(2). For such an interpretation, see eg NAFTA Free Trade Commission, 'Notes of Interpretation of Certain Chapter 11 Provisions' (31 July 2001), available at <<http://www.international.gc.ca/trade-agreements-accords-commerciaux/disp-diff/NAFTA-Interpr.aspx?lang=en>>. Likewise, the 2004 US Model BIT provides for a similar treaty-based body. See US Model BIT 2004, art 30(3): 'A joint declaration of the Parties, each acting through its representative designated for purposes of this Article declaring their interpretation of a provision of this Treaty shall be binding on a tribunal, and any decision or award issued by a tribunal must be consistent with that joint decision.'

of proportionality analysis to constitutional rights has some parallels with its application in the context of interpreting investor rights under investment treaties, national constitutional courts and standing international courts, such as the ECJ and the ECtHR, may well be in a better institutional position to bear this weight than are ad hoc and evanescent investment treaty tribunals.

Yet investment treaty tribunals are already exercising far-reaching functions and applying very open-textured standards in situations where important public interests are involved. Given that reality, and the possibilities of at least a loose structure of control through institutional supervision and checking by other tribunals, as well as critical scrutiny by the academic and legal practitioner communities, think-tanks, and NGOs, the adoption of a proportionality methodology at a minimum establishes criteria and a framework to ensure that tribunals consider the relevant interests under the applicable principles, and weigh or balance them under an established framework. This may produce better and more convincing reasoning, and enable clearer assessment, critique, and accountability of tribunals. A proportionality analysis certainly seems preferable as a rational process for balancing investment protection and competing interests, by comparison with approaches in which an extensive summary of the facts of the case at hand is followed by the abrupt determination, with little intelligible legal reasoning, that a state's measure does or does not violate fair and equitable treatment, or constitute a measure tantamount to expropriation, or does or does not fall under a non-precluded measures clause of an investment treaty.

Certainly, proportionality analysis can be criticized as legitimating judicial law-making and as generating a *gouvernement des juges*. But it is more robust than some of the alternative methods for dealing with the difficult assessments that currently are made in international investment law. Without proportionality analysis the concept of indirect expropriation, for example, risks degrading to an analysis without rationalization: 'I know it when I see it.'<sup>112</sup> Similarly, some subsets of the standard of fair and equitable treatment would, instead of following a structured analysis about the relationship between the investor's expectations and competing public interests in the application of rule of law standards and the balance between the two, become open to subjective assessments of arbitrators about what they consider fair and equitable—a standard of equity, not a legal standard that has normative content. Proportionality, in this respect, may provide more predictability than the lack of any intelligible standard of weighing and balancing, in particular if the procedural aspect or version of proportionality analysis is emphasized, instead of the more substantive versions undertaken under this heading by some domestic courts.

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<sup>112</sup> cf Fortier and Drymer (n 6 above) 293.

Proportionality analysis also has the advantage that it is open towards different strands of political theory and different substantive preferences on investment protection.<sup>113</sup> It is potentially attractive both to those stressing that tribunals should more broadly take into account non-investment related interests of non-represented parties that are affected by the outcome of a tribunal's decision, and to those seeking to tighten the legal framework of state interferences with foreign investment. Furthermore, the methodological structure of proportionality analysis may have the effect that arbitrators become more accountable since they also have to justify their decisions in a detailed fashion. Proportionality analysis thus has the potential to become a tool to enhance accountability and justification for governmental action and the activity of arbitral tribunals alike. Finally, proportionality analysis can constitute a gateway for non-investment law principles to enter into the argumentative framework of investment treaty arbitration and thereby help to overcome the fragmentation of international law into functional and special-interest-related sub-systems.

In summary, while reasons for hesitation must be acknowledged, the principle of proportionality has the potential to help structure both the relationships between states and foreign investors and between states and investment tribunals, and the relationship between international investment law and other sub-areas of international law. In consequence, it may provide one way to counter risks of clinical isolation of international investment law, and to build some degree of coherence into aspects of an international economic order. It is probable that proportionality analysis, if done well and with due circumspection, could potentially enhance the legitimacy of rule-governed legal institutions that undertake it. As a study of the adoption of proportionality analysis by more and more national and international courts concludes: 'In adopting the proportionality framework, constitutional judges acquire a coherent, practical means of responding to these basic legitimacy questions.'<sup>114</sup> Intense concerns about legitimacy in the system of international investment treaty law could drive a rapid adoption of proportionality analysis as a standard technique. This could well be one step towards investment treaty tribunals recognizing and meeting the demands that their place in global regulatory structures and their function as public law adjudicators now imposes upon them.

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<sup>113</sup> cf Andenas and Zleptnig (n 14 above) 387, drawing on the work of Paul Craig on judicial review of agency decisions in the UK.

<sup>114</sup> Stone Sweet and Mathews (n 15 above) 80.